LUDWIG VON MISES

The Free Market and Its Enemies:

Pseudo-Science, Socialism, and Inflation

With an Introduction by Richard M. Ebeling

Foundations of Freedom

MISES SEMINAR LECTURES, VOLUME I

The Free Market and Its Enemies:

Pseudo-Science, Socialism, and Inflation

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Pseudo-Science, Socialism, and Inflation

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GUATEMALA

BY LUDWIG VON MISES

With an Introduction by Richard M. Ebeling

Lecture Transcriptions by Bettina Bien Greaves

FOUNDATION FOR ECONOMIC EDUCATION
Irvington-on-Hudson, NY 10533

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These lectures, delivered by Ludwig von Mises at the Foundation for Economic Education in the summer of 1951, would not exist if not for Bettina Bien Greaves, who took them down word for word in shorthand, and who kindly made the transcriptions available to FEE. Mrs. Greaves served as a senior staff member at the Foundation for almost 50 years, until her retirement in 1999. She and her late husband, Percy L. Greaves, Jr., were among Mises's closest friends. Her appreciation and understanding of Mises's works have helped keep his legacy alive for a new generation of friends of freedom.

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Mrs. Beth Hoffman, managing editor of FEE's monthly publication, *The Freeman*, has overseen the preparation of the manuscript from beginning to end with her usual professional care.

INTRODUCTION

by Richard M. Ebeling

OVER A TWELVE-DAY PERIOD, from June 25 to July 6, 1951, the internationally renowned Austrian economist Ludwig von Mises delivered a series of lectures at the Foundation for Economic Education (FEE) at its headquarters in Irvington-on-Hudson, New York. Bettina Bien Greaves, a FEE staff member at that time, took down Mises's lectures in shorthand, word for word, and then transcribed them into a full manuscript. It has remained unpublished until now.

FEE is proud to finally make these lectures available to a new generation. Mises was almost 70 years old when he spoke the words that are in this text, but they reveal a vitality of mind that is youthful in its clarity and vision of the free market and its critical analysis of freedom's enemies.

Ludwig von Mises: His Life and Contributions

During the decades before Mises gave these lectures at FEE he had established himself as one of the leading voices of freedom in the Western world.[1]

Ludwig von Mises was born on September 29, 1881, in Lemberg, the capital of the province of Galicia in the old Austro-Hungarian Empire (now known as Lvov in western Ukraine). He graduated from the University of Vienna in 1906 with a doctoral degree in jurisprudence, and

1 On Mises's life and contributions to economics and the philosophy of freedom, see Richard M. Ebeling, *Austrian Economics and the Political Economy of Freedom* (Northampton, Mass.: Edward Elgar, 2003), Ch. 3, "A Rational Economist in an Irrational Age: Ludwig von Mises," pp. 61–99; and Richard M. Ebeling, "Planning for Freedom: Ludwig von Mises as Political Economist and Policy Analyst" in Richard M. Ebeling, ed., *Competition or Compulsion: The Market Economy versus the New Social Engineering* (Hillsdale, Mich.: Hillsdale College Press, 2001), pp. 1–85; see also Murray N. Rothbard, *Ludwig von Mises: Scholar, Creator, Hero* (Auburn, Ala.: Ludwig von Mises Institute, 1988), and Israel M. Kirzner, *Ludwig von Mises* (Wilmington, Del.: ISI Books, 2001).

a specialization in economics. After briefly working as a law clerk, he was hired by the Vienna Chamber of Commerce, Crafts, and Industry in 1909, and within a few years was promoted to the position of one of the Chamber's senior economic analysts.

Mises was soon recognized as one of the most insightful and penetrating minds in Austria. In 1912, he published *The Theory of Money and Credit,* a book that was quickly hailed as a major work on monetary theory and policy, in which he first presented what became known as the Austrian Theory of the Business Cycle. Inflations and depressions were not inherent within a free-market economy, Mises argued, but were caused by government mismanagement of the monetary and banking systems.[2]

His scholarly work was interrupted in 1914, however, with the coming of the First World War. For the next four years, Mises served as an officer in the Austrian Army, most of that time on the eastern front against the Russian Army. He was three times decorated for bravery under fire. After Lenin and the Bolsheviks signed a separate peace with Imperial Germany and Austria-Hungary in March 1918 that withdrew Russia from the war, Mises was appointed the officer in charge of currency control in that part of the Ukraine occupied by the Austrian Army under the terms of the peace treaty, with his headquarters in the port city of Odessa on the Black Sea. During the last several months of the war, before the armistice of November 11, 1918, Mises was stationed in Vienna serving as an economic analyst for the Austrian High Command.

After being mustered out of the army at the end of 1918, he returned to his duties at the Vienna Chamber of Commerce, with the additional responsibility, until 1920, of being in charge of a branch of the League of Nations' Reparations Commission overseeing the settlement of prewar debt obligations.

In the years immediately following the war, Austria was in a state of chaos. The old Austro-Hungarian Empire broke up, leaving a new, much smaller Republic of Austria. Hyperinflation and aggressive trade barriers by neighboring countries soon reduced much of the Austrian population to near-starvation conditions. In addition, there were several attempts to

2 Ludwig von Mises, *The Theory of Money and Credit* (Indianapolis: Liberty Classics [1912; revised eds., 1924, 1953] 1980); and also by Mises, "Monetary Stabilization and Cyclical Policy" [1928] reprinted in Israel M. Kirzner, ed., *Austrian Economics: A Sampling in the History of a Tradition,* Vol. 3: *The Age of Mises and Hayek* (London: William Pickering, 1994), pp. 33–111.

violently establish a revolutionary socialist regime in Austria, as well as border wars with Czechoslovakia, Hungary, and Yugoslavia.

From his position at the Vienna Chamber of Commerce, Mises fought day and night to ward off the collectivist destruction of his homeland. He was influential in stopping the full nationalization of Austrian industry by the government in 1918–1919. He also played a leading role in bringing the hyperinflation in Austria to a halt in 1922, and then was a guiding voice in reorganizing the Austrian National Bank under a re-established gold standard under League of Nations supervision. He also forcefully made the case for drastically lowering the income and business taxes that were strangling all private-sector activities, and assisted in bringing to an end the government's foreign-exchange controls that were ruining Austria's trade with the rest of the world.[3]

Throughout the 1920s and early 1930s, while in his native Austria, Mises was an uncompromising defender of the ideals of individual liberty, limited government, and the free market. Besides his work at the Vienna Chamber of Commerce, he taught a seminar every semester at the University of Vienna on various aspects of economic theory and policy, which attracted not only many of the brightest Austrian students but attendees from the rest of Europe and the United States as well. He also led a "private seminar" that met twice a month from October to June in his Chamber offices, from 1920 to 1934, with many of the best Viennese minds in economics, political science, history, philosophy, and sociology regularly participating.

Mises also founded the Austrian Institute for Business Cycle Research in 1926. He served as acting vice-president, with a young Friedrich A. Hayek appointed as the Institute's first director.

His international stature as a champion of classical liberalism continued to grow during this period, as well, through a series of books that challenged the rising tide of socialism and the interventionist-welfare state. In

3 On Mises's work as an economic policy analyst and advocate of the free market in Austria in the years between the two World Wars, see Richard M. Ebeling, "The Economist as the Historian of Decline: Ludwig von Mises and Austria Between the Two World Wars" in Richard M. Ebeling, ed., *Globalization: Will Freedom or World Government Dominate the International Marketplace?* (Hillsdale, Mich.: Hillsdale College Press, 2002), pp. 1–68. Many of Mises's articles and policy papers during this period are now available; see Richard M. Ebeling, ed., *Selected Writings of Ludwig von Mises, Vol. 2: Between the Two World Wars: Monetary Disorder, Interventionism, Socialism and the Great Depression* (Indianapolis: Liberty Fund, 2002).

1919, Mises published *Nation, State and Economy,* in which he traced out the causes of the First World War in the nationalist, imperialist, and socialist ideas of the preceding decades.[4] But it was in a 1920 article on "Economic Calculation in the Socialist Commonwealth"[5] and his 1922 book on *Socialism: An Economic and Sociological Analysis* that his reputation as the leading opponent of collectivism in the twentieth century was firmly established.[6] Mises demonstrated that with the nationalization of the means of production, and the resulting abolition of money, market competition, and the price system, socialism would lead to economic chaos and not to social prosperity. Thus, besides the tyranny that socialism would create due to the government's domination over all aspects of human life, it was also inherently unworkable as an economic system.

This was followed in 1927 with his defense of all facets of individual freedom in his book on *Liberalism,* by which he meant classical liberalism and the market economy. He presented a clear and persuasive case for individual liberty, private property, free markets, and limited government.[7] Finally, in 1929, Mises published a collection of essays offering a *Critique of Interventionism,* in which he showed that government piecemeal regulations over prices and production inevitably lead to distortions and imbalances that threaten the effective functioning of a free and competitive market society.[8] In addition, he penned a series of essays on the philosophy of science and the nature of man and the social order that appeared in 1933 under the title *Epistemological Problems of Economics.*[9]

Mises had clearly understood during this time that Hitler's National Socialism would lead Germany down the road to destruction. In fact, in the mid-1920s, he had already warned that too many Germans were hoping for the coming of the tyrant who would rule over and plan their

4 Ludwig von Mises, *Nation, State and Economy: Contributions to the Politics and History of Our Time* (New York: New York University Press [1919] 1983).

5 Ludwig von Mises, "Economic Calculation in the Socialist Commonwealth" [1920] reprinted in Israel M. Kirzner, ed., *Austrian Economics: A Sampling in the History of a Tradition,* Vol. 3: *The Age of Mises and Hayek,* pp. 3–35.

6 Ludwig von Mises, *Socialism: An Economic and Sociological Analysis* (Indianapolis: Liberty Classics [1922; revised eds., 1932, 1951] 1981).

7 Ludwig von Mises, *Liberalism: The Classical Tradition* (Irvington-on-Hudson, N.Y.: Foundation for Economic Education [1927] 1995).

8 Ludwig von Mises, *Critique of Interventionism* (Irvington-on-Hudson, N.Y.: Foundation for Economic Education [1929] 1996).

9 Ludwig von Mises, *Epistemological Problems of Economics* (New York: New York University Press [1933] 1981).

lives.[10] When the Nazis came to power in Germany in 1933, Mises understood that the future of his native Austria was now threatened. As a classical liberal and a Jew, Mises also knew that a Nazi takeover would probably mean his arrest and death. So, in 1934 he accepted a position as professor of international economic relations at the Graduate Institute of International Studies in Geneva, Switzerland, a position that he held until he came to the United States in the summer of 1940.[11]

It was during those six years in Switzerland that Mises wrote his greatest work, the German-language edition of which was published in Geneva in 1940,[12] and which then appeared in 1949 in a revised English-language version as *Human Action: A Treatise on Economics.*[13] In a volume of almost 900 pages, Mises summarized the ideas and reflections of a lifetime on the issues of man, society, and government; on the nature and workings of the competitive market process and the impossibilities of socialist central planning and the interventionist state; and on the central role and importance of a sound monetary system for all market activities, and the harmful effects from government's manipulation of money and credit.

In the summer of 1940, as the German Army was overrunning France, Mises and his wife, Margit, left neutral Switzerland and made their way through southern France and across Spain to Lisbon, Portugal, from where they then sailed to the United States. Living in New York City, he received research grants from the Rockefeller Foundation in the early 1940s that enabled him to do a number of studies on postwar economic and political reconstruction, as well as write several books.[14] In 1945, he was appointed to a visiting professorship at New York University, a position that he held until his retirement in 1969 at the age of 87.

10 In his 1926 essay, "Social Liberalism," reprinted in *Critique of Interventionism,* p. 67, Mises warned that during the time of ideological confusion and political instability in the Germany of the 1920s, "Some are taking refuge in mysticism, others are setting their hopes on the coming of the 'strong man'—the tyrant who will think for them and care for them."

11 On the Graduate Institute of International Studies and its founder, William E. Rappard, see Richard M. Ebeling, "William E. Rappard: An International Man in an Age of Nationalism," *Ideas on Liberty* (Jan. 2000), pp. 33–41.

12 Ludwig von Mises, *Nationalökonomie: Theorie des Handelns und Wirtschaftens* (Munich: Philosophia Verlag [1940] 1980).

13 Ludwig von Mises, *Human Action: A Treatise on Economics* (Irvington-on-Hudson, N.Y.: Foundation for Economic Education [1949; revised eds., 1963, 1966] 1996).

14 A number of Mises's essays from this period, 1940–1944, are included in Richard M. Ebeling, ed., *Selected Writings of Ludwig von Mises,* Vol. 3: *The Political Economy of International Reform and Reconstruction* (Indianapolis: Liberty Fund, 2000).

During his years in America, Mises continued his prolific writing career, publishing *Bureaucracy* (1944),[15] *Omnipotent Government* (1944),[16] *Planned Chaos* (1947),[17] *Planning for Freedom* (1952),[18] *The Anti-Capitalistic Mentality* (1956),[19] *Theory and History* (1957),[20] *The Ultimate Foundation of Economic Science* (1962),[21] and *The Historical Setting of the Austrian School of Economics* (1969).[22] There also appeared, posthumously, his memoirs, *Notes and Recollections* (1978),[23] and *Interventionism: An Economic Analysis* (1998),[24] both originally written in 1940. And many of his other articles and essays have been collected in two anthologies.[25]

Mises also attracted around him a new generation of young Americans dedicated to the ideal of liberty and economic freedom, and who were encouraged and assisted by Mises in their intellectual activities. He passed away on October 10, 1973, at the age of 92.

Ludwig von Mises and FEE

There was a long relationship between Ludwig von Mises and the Foundation for Economic Education. The late Leonard E. Read, the founder and first president of FEE, met Mises in the early 1940s. Read told the story of their meeting in an essay he wrote in honor of Mises's 90th birthday:

15 Ludwig von Mises, *Bureaucracy* (New Haven: Yale University Press, 1944).

16 Ludwig von Mises, *Omnipotent Government: The Rise of the Total State and Total War* (New Haven: Yale University Press, 1944).

17 Ludwig von Mises, *Planned Chaos* (Irvington-on-Hudson, N.Y.: Foundation for Economic Education, 1947).

18 Ludwig von Mises, *Planning for Freedom* (Grove City, Pa.: Libertarian Press [1952; revised ed., 1962, 1980] 1996).

19 Ludwig von Mises, *The Anti-Capitalistic Mentality* (Princeton: D. Van Nostrand, 1956).

20 Ludwig von Mises, *Theory and History: An Interpretation of Social and Economic Evolution* (Auburn, Ala.: Ludwig von Mises Institute [1957] 1985).

21 Ludwig von Mises, *The Ultimate Foundation of Economic Science: An Essay on Method* (Irvington-on-Hudson, N.Y.: Foundation for Economic Education [1962] 2002).

22 Ludwig von Mises, "The Historical Setting of the Austrian School of Economics" [1969] reprinted in Bettina Bien Greaves, ed., *Austrian Economics: An Anthology* (Irvington-on-Hudson, N.Y.: Foundation for Economic Education, 1996), pp. 53–76.

23 Ludwig von Mises, *Notes and Recollections* (South Holland, Ill.: Libertarian Press [1940] 1978).

24 Ludwig von Mises, *Interventionism: An Economic Analysis* (Irvington-on-Hudson, N.Y.: Foundation for Economic Education [1940] 1998).

25 See Richard M. Ebeling, ed., *Money, Method and the Market Process: Essays by Ludwig von Mises* (Norwell, Mass.: Kluwer Academic Press, 1990), and Bettina Bien Greaves, ed., *Economic Freedom and Interventionism: An Anthology of Articles and Essays by Ludwig von Mises* (Irvington-on-Hudson, N.Y.: Foundation for Economic Education, 1990).

Professor Ludwig von Mises arrived in America during 1940. My acquaintance with him began a year or two later when he addressed a luncheon meeting of the Los Angeles Chamber of Commerce of which I was General Manager. That evening he dined at my home with renowned economists Dr. Benjamin M. Anderson and Professor Thomas Nixon Carver, and several businessmen such as W. C. Mullendore, all first-rate thinkers in political economy. What I would give for a recording of that memorable discussion!

The final question was posed at midnight: "Professor Mises, I agree with you that we are headed for troublous times. Now, let us suppose you were the dictator of these United States. What would you do?"

Quick as a flash came the reply, *"I would abdicate!"* Here we have the renunciation side of wisdom: man knowing he should not lord it over his fellows and rejecting even the thought.

Few among us are wise enough to know how little we know. . . . A rare individual weighs his finite knowledge on the scale of infinite truth, and his awareness of his limitation tells him never to lord it over others. Such a person would renounce any position of authoritarian rulership he might be proffered or, if accidentally finding himself in such a position, would abdicate—forthwith! . . .

Professor Mises knows that he does not or cannot rule; thus, he abdicates from even the idea of rulership. Knowing what phase of life to renounce is one side of wisdom.[26]

From FEE's founding in 1946, Ludwig von Mises served as a senior adviser, lecturer, writer, and part-time staff member for the Foundation. It was through Mises's influence and that of free-market economist and journalist Henry Hazlitt (one of FEE's original trustees) that the Foundation has always had a special "Austrian School" orientation to its economic analysis of free markets and collectivism.[27]

26 Leonard E. Read, "To Abdicate or Not" in F. A. Harper, ed., *Toward Liberty: Essays in Honor of Ludwig von Mises on the Occasion of His 90th Birthday, September 29, 1971*, Vol. 2 (Menlo Park, Calif.: Institute for Humane Studies, 1971), pp. 299–301.

27 Mary Sennholz, *Leonard E. Read: Philosopher of Freedom* (Irvington-on-Hudson, N.Y.: Foundation for Economic Education, 1993), p. 140.

It was also through the assistance of Leonard Read and a few others among Mises's friends that funding was arranged to underwrite his teaching position at NYU, until his retirement in 1969. And following his departure from NYU, Leonard Read brought Mises onto FEE's staff for the remainder of his life.

Mises's wife, Margit, described his appreciation of FEE and the opportunity to lecture at the Foundation:

> In October 1946, Lu was made a regular member of the FEE staff, and in later years he promised to give a series of lectures in Irvington every year. The spiritual and intellectual atmosphere there was completely to his taste.
>
> * * *
>
> One of the regular tasks of the Foundation was to arrange seminars for teachers, journalists and students. Lu enjoyed speaking there. He knew the participants were carefully questioned about their education and interests and were eager to hear him. It was interesting to note how many women attended these seminars.
>
> Before the classes started, Lu regularly made the rounds. First, he had a little talk with Read; then he went to see Edmund Opitz, for whom he had a special appreciation; then he visited with W. Marshall Curtiss and Paul Poirot. Paul usually had to discuss an article he was about to publish in *The Freeman,* FEE's monthly magazine. Finally, Lu went into Bettina Bien's office. As a rule, Bettina had a pile of his books ready for him to autograph or letters to sign, which were typed for him in his office. On his way down to the lecture hall—all these offices, with the exception of that of Dr. Opitz, were on the second floor—he had a friendly word for every one of the employees.
>
> His lectures were calculated for a special Irvington audience. He was able to evaluate his listeners immediately by asking one or the other question. . . . Though the content of his lectures in Irvington was lighter, his mode of delivery was the same as at New York University. The interest was great and so was the demand for Lu's books, which Leonard Read always kept in print and ready for distribution.[28]

28 Margit von Mises, *My Years with Ludwig von Mises* (Cedar Falls, Iowa: Center for Futures Education [1976] 2nd enlarged ed., 1984), pp. 94–95.

Mises's last public lecture was delivered at FEE on March 26, 1971. As Margit von Mises explained: "He always loved lecturing in Irvington, and he continued doing so as long as he felt able."[29]

When Mises passed away, Leonard Read delivered a brief eulogy at the memorial service for him on October 16, 1973. He said, in part:

> The proudest tribute mankind can pay to one it would most honor is to call him Teacher. The man who releases an idea which helps men understand themselves and the universe puts mankind forever in his debt. . . . Ludwig von Mises is truly—and I use this in the present tense—a Teacher. More than two generations have studied under him and countless thousands of others have learned from his books. Books and students are the enduring monuments of a Teacher and these monuments are his. . . . We have learned more from Ludwig Mises than economics. We have come to know an exemplar of scholarship, a veritable giant of erudition, steadfastness, and dedication. Truly one of the great Teachers of all time! And so, all of us salute you, Ludwig Mises, as you depart this mortal life and join the immortals.[30]

The FEE Lectures of 1951

For those readers who are already familiar with some of Mises's works, his 1951 lectures at FEE will offer them a slightly different style to his analysis. Here is Mises the teacher. The form of exposition that Bettina Bien Greaves has captured in her detailed shorthand of his lectures is more colloquial, and full of many historical examples and references. The reader is able to feel, at least a bit, what Mises was like face to face in the classroom, and not simply the Olympian theorist in his great tomes.

One of Mises's students who studied with him at New York University once said that "Every lecture was a mind-stretching experience." Another student declared that "I have never known a man as erudite as was Dr. Mises. He was extraordinarily learned in every field of knowledge. In discussing economics he would bring in examples from history to illustrate

29 Ibid., pp. 177–178.

30 Leonard Read, *Castles in the Air* (Irvington-on-Hudson, N.Y.: Foundation for Economic Education, 1975), pp. 150–151.

the points he was making."[31] His FEE lectures from 1951 give a taste of this side of Mises as a scholar-teacher.

For the readers who are relatively unfamiliar with Mises's writings, these lectures offer an excellent starting point. Indeed, in many ways the lectures present an encapsulated version of most of the themes that Mises devoted his life to formulating, a summary of many of the central themes to be found in *Human Action*. He explains the nature of man as a purposeful actor who gives meaning to his actions in the context of ends chosen and means selected to achieve his goals. It is the intentionality of man that makes the human sciences inherently different from the subject matter of the natural sciences. This also enables Mises to demonstrate why Karl Marx's theory of dialectical materialism and historical determinism is fundamentally myth and fantasy.

Instead, he shows the actual workings of the market process through which economic freedom provides the incentives and the personal liberty for individuals to work, save, and invest. He explains how it is the consumer-driven demand for goods and services that provides the stimulus and profit opportunities for entrepreneurs to creatively arrange and guide production in ways that serve the wants and desires of the buying public.

He also demonstrates that the market process is dependent upon and would be impossible without the emergence of a medium of exchange—money—through which all the myriad of goods and resources can be reduced to a common denominator in the form of money prices. Economic calculation in the form of market prices provides the method through which entrepreneurs are able to estimate potential profits and possible losses from alternative lines and methods of production. Through this process, waste and misuse of scarce resources are kept to a minimum, so that as many of the most highly valued goods and services desired by consumers may be brought to market.

This also leads Mises to explain why socialist central planning means the end of all economic rationality. With the abolition of markets and prices under socialism, the central planners are clueless about how to efficiently apply the resources, capital, and labor under their control. Hence, socialism in practice means planned chaos.

At the same time, Mises shows why government mismanagement of

31 Ibid., p. 132.

the monetary and banking system brings about inflations and depressions. By distorting the price signals of the marketplace—including interest rates—government-generated inflations bring about a misdirection of resources and labor and a malinvestment of capital, which finally must lead to a depression.

Through these lectures, the reader will see why Ludwig von Mises was one of the most effective proponents of freedom and free enterprise in the twentieth century. And why his contributions will remain as one of the great legacies in the cause of liberty in the many decades to come.

1ST LECTURE

Economics and Its Opponents

AMONG THE GREAT BOOKS OF MANKIND are the immortal writings by the Greek philosopher Plato. *The Republic* and *The Laws,* written 2300 to 2400 years ago, dealt not only with philosophy, the theory of knowledge, epistemology, but also with social conditions. The treatment of these problems was typical of the approach which philosophical and sociological problems, discussions of state, government, and so on, continued to receive for more than 2000 years.

Although this approach is familiar to us, a new point of view toward social philosophy, the sciences, economics, and praxeology has developed during the last hundred years. Plato had said that a leader is called on by "Providence" or by his own eminence, to reorganize and to construct the world in the same way that a builder constructs a building—without bothering with the wishes of his fellowmen. Plato's philosophy was that most men are "tools" and "stones" to be worked with for the construction of a new social entity by the "superman" in control. The cooperation of the "subjects" is unimportant for the success of the plan. The only requirement is that the dictator have the requisite power to force the people. Plato assigns to himself the specific task of being adviser to the dictator, the specialist, the "social engineer" reconstructing the world according to his plan. A comparable situation today may be seen in the position of the college professor who goes to Washington.

The Platonic pattern remained the same for almost 2,000 years. All the books of that era were written from this point of view. Each author was convinced that men were merely pawns in the hands of the princes, the

police, and so on. Anything could be done, provided the government was strong enough. Strength was considered the greatest asset of government.

An indication of the success of this thinking may be realized in reading the adventures of *Télémaque* by Bishop Fénelon [François de Salignac de la Mothe Fénelon, 1651–1715]. Bishop Fénelon, a contemporary of Louis XIV, was an eminent and great philosopher, a critic of government, and tutor to the Duke of Burgoyne, heir to the French throne. *Télémaque,* written for the young Duke's education, was used in French schools until recently. The book tells of world travels. In each country visited, all that is good is credited to the police; everything of value is attributed to the government. This is known as the "science of the police"—or in German *Polizeiwissenschaft.*

The eighteenth century saw a new discovery—the discovery of a different approach to social problems. The idea developed that there was a regularity in the sequence of social problems similar to the regularity in the sequence of natural phenomena. It was learned that legal decrees and their enforcement alone would not remove an ill. The regular sequence or concatenation of social phenomena must be studied to find out what can be done, and what should be done. Although regularity had been recognized in the field of the natural sciences, the existence of order and of regular sequences also in the field of social problems had not been recognized before.

The Utopian conditions of the natural state, as described by Jean Jacques Rousseau [1712–1778], are transformed, it was held, by "wicked" men and by their evil social institutions to produce the destitution and misery that exists. It was believed that the happiest man—the one living under the most satisfactory conditions—was the Indian of North America. North American Indians were idealized in European literature of that time; they were considered happy because they were not acquainted with modern civilization.

Then came Thomas Robert Malthus [1766–1834] with the discovery that nature does not provide the means of existence for everybody. Malthus pointed out that there prevails for all humans a scarcity of the requirements of subsistence. All men are in competition for the means of survival and for a share of the world's wealth. The aim of man was to remove the scarcity and make it possible for a greater number of persons to survive.

Competition leads to the division of labor and to the development of cooperation. The discovery that the division of labor is more productive

than isolated labor was the happy accident that made social cooperation, social institutions, and civilization possible.

If all production is consumed immediately, any improvement of conditions would be impossible. Improvement is possible only because some production is saved for use in later production—that is only if capital is accumulated. *Savings are important!*

In the eyes of all reformers such as Plato, the "body politic" could not operate without interference from the top. Intervention by the "king," by government, and by the police was necessary to obtain action and results. Remember that this was also the theory of Fénelon; he described the streets, factories, and all progress as being due to the police.

In the eighteenth century, it was discovered that even in the absence of the police—even if no one gives orders—people naturally act in such a way that the fruits of production finally appear. Adam Smith [1723–1790] cited the shoemaker. The shoemaker doesn't make shoes from an altruistic motive; the shoemaker provides us with shoes because of his own selfish interest. Shoemakers produce shoes because they want the products of others which they can get in exchange for shoes. Every man, in serving himself, of necessity serves the interest of others. The "king" doesn't have to issue orders. Action is brought about, therefore, by the autonomous actions of people in the market.

The eighteenth century's discoveries with respect to social problems were closely connected with, and inseparable from, the political changes brought about during that period—the substitution of representative for autocratic government, free trade for protection, the tendency toward international peace instead of aggressiveness, the abolition of serfdom and slavery, and so on. The new political philosophy also led to substituting liberty for monarchism and absolutism. And it brought about changes in industrial life and social life which altered the fact of the world in a very short time. This transformation is customarily called the Industrial Revolution. And this "revolution" resulted in changes in the whole structure of the world, populations multiplied, the average length of life expectancy increased, and standards of living rose.

With specific reference to the population, it is four times greater today [1951] than it was more than 250 years ago. If Asia and Africa are eliminated, the growth is even more startling. Great Britain, Germany, and Italy, three countries that were completely settled and where every bit of land was already in use by 1800, found room to support 107 million more

people by 1925. (This seems all the more remarkable when compared with the United States—many times the area of these three countries—which increased its population by only 109 million in that same period.) At the same time, the standard of living was raised everywhere as a result of the Industrial Revolution by the introduction of mass production.

Of course, there are still unsatisfactory conditions; there are still situations that can be improved. To this, the new philosophy responds: *There is only one way to improve the standard of living of the population—increase capital accumulation as against the increase in population. Increase the amount of capital invested per capita.*

Although this new doctrine of economic theory was true, it was unpopular for many reasons with certain groups—monarchs, despots, and nobles—because it endangered their vested interests. In the nineteenth and twentieth centuries, these opponents of this eighteenth-century philosophy developed a number of objections, epistemological objections which attacked the basic foundation of the new philosophy and raised many very serious and important problems. Their attack was more or less a philosophical attack, directed at the epistemological foundations of the new science. Almost all their criticism was motivated by political bias; it was not brought forth by searchers for the truth. However, this does not alter the fact that we should study seriously the objections to the various truths of the eighteenth century—sound philosophy and economics—without reference to the motives of those who bring them forth. Some were well founded.

During the last hundred years, opposition to sound economics has arisen. This is a very serious matter. The objections raised have been used as arguments against the whole bourgeois civilization. These objections cannot be simply called "ridiculous" and dismissed. They must be studied and critically analyzed. As far as the political problem is concerned, some people who supported sound economics did so in order to justify, or to defend, the bourgeois civilization. But these defenders didn't know the whole story. They limited their fighting to a very small territory, similar to the situation today in Korea where one army is forbidden to attack the strongholds of the other army.[1] In the intellectual struggle, the same

1 [After the capture of the North Korean stronghold, Pyongyang, it became evident that the armies of Communist China were amassing for attack north of the Yalu River, the boundary between North Korea and Communist-controlled Manchuria. Yet requests by General Douglas MacArthur to do anything to forestall an attack were denied; his planes were not allowed to bomb the bridges over the Yalu; and the Red Chinese forces were even granted a five-mile-deep sanctuary south of the Yalu where they could assemble.—Ed.]

situation exists; the defenders are fighting without attacking the real foundation of their adversaries. We must not be content to deal with the external paraphernalia of a doctrine; we must attack the basic philosophical problem.

The distinction between "left" and "right" in politics is absolutely worthless. This distinction has been inadequate from the very beginning and has brought about a lot of misunderstanding. Even objections to the basic philosophy are classified from that point of view.

Auguste Comte [1798–1857] was one of the most influential philosophers of the nineteenth century, and probably one of the most influential men of the last hundred years. In my own private opinion, he was a lunatic as well. Although the ideas he expounded were not even his own, we must deal with his writings because he was influential and especially because he was hostile to the Christian church. He invented his own church, with its own holidays. He advocated "real freedom," more freedom, he said, than was offered by the bourgeoisie. According to his books, he had no use for metaphysics, for freedom of science, for freedom of the press, or for freedom of thought. All these were very important in the past because they gave him the opportunity to write his books, but in the future there would be no need for such freedom because his books had already been written. So the police must repress these freedoms.

This opposition to freedom, the Marxian attitude, is typical of those on the "left" or "progressive" side. People are surprised to learn that the so-called "liberals" are not in favor of freedom. Georg Wilhelm Friedrich Hegel [1770–1831], the famous German philosopher, gave rise to two schools—the "left" Hegelians and the "right" Hegelians. Karl Marx [1818–1883] was the most important of the "left" Hegelians. The Nazis came from the "right" Hegelians.

The problem is to study basic philosophy. One good question is why have the Marxists been to a certain extent familiar with the great philosophical struggle, while the defenders of freedom were not? The failure of the defenders of freedom to recognize the basic philosophical issue explains why they have not been successful. We must first understand the basis for the disagreement; if we do, then the answers will come. We will now proceed to the objections that have been raised to the eighteenth-century philosophy of freedom.

2ND LECTURE

Pseudo-Science and Historical Understanding

IN THE ENGLISH LANGUAGE, the word "science" is usually applied only to the natural sciences. There is no doubt that there are fundamental differences between the natural sciences and the science of human action, sometimes called social science or history. Among these fundamental differences is the way in which knowledge is acquired.

In the natural sciences knowledge comes from experiment; a fact is something experimentally established. Natural scientists, in contrast to students of human action, are in a position of being able to control changes. They can isolate the various factors involved, as in a laboratory experiment, and observe changes when one factor is changed. The theory of a natural science must conform to these experiments—they must never contradict such an established fact. Should they contradict such a fact, a new explanation must be sought. In the field of human action, we are never in a position of being able to control experiments. We can never talk of facts in the field of social sciences in the same sense in which we refer to facts in the natural sciences. Experience in the field of human action is complicated, produced by the cooperation of various factors, all effecting change.

In the field of nature we have no knowledge of final causes. We do not know the ends for which some "power" is striving. Some persons have attempted to explain the universe as if it had been intended for the use of man. But questions can then be raised: What is the value to man of flies, for instance, or of germs? In the natural sciences we know nothing but experience. We are familiar with certain phenomena and on the basis of

experiments a science of mechanics has been developed. But we do not know what electricity is. We don't know why things happen the way they do; we don't ask. And if we do ask, we don't receive an answer. To say we know the answer implies that we have ideas of "God." To assert that we can find the reason implies that we have certain "God-like" characteristics.

There is always a point beyond which the human mind can go—a realm into which inquiry brings no more information. Through the years this frontier has been pushed farther and farther back. Natural forces have been traced back beyond what was formerly considered "ultimate" human knowledge. But human knowledge must *always* stop at some "ultimate given." The French physiologist Claude Bernard [1813–1878] said in his book on experimental science that life itself is something "ultimately given"; biology can only establish the fact that there is such a phenomenon as life, but it can say nothing more about it.

The situation is different in the field of history or of human action. There we can trace our knowledge back to something behind the action; we can trace it back to the motive. Human actions imply that men are aiming at definite goals. The "ultimate given" in the field of human action is the point at which an individual or a group of individuals, inspired by definite judgments of value and by definite ideas as to the procedures to be applied to attain a chosen end, acted. This "ultimate given" is *individuality.*

Being human we know something about human evaluations, doctrines, and theories concerning the methods used to reach these ends. We know there is some purpose behind the various moves of individuals. We know there is conscious action on the part of each person. We know there is a sense, a reason. We can establish that there are definite judgments of value, definite ends aimed at, and definite means applied in the attempt to gain these ends. For example a stranger, dropped suddenly into a primitive tribe, although ignorant of the language, can nevertheless interpret the actions of the people about him to some extent, the ends toward which they are working, and the means used to attain the ends. Through logic he interprets their running around building fires and putting objects in kettles as preparing food for dinner.

Dealing with judgments of value and methods is not peculiar to the science of human action. The logic of the scientist, the brainwork, is no different from the logic practiced by everybody in his daily life. The tools are the same. The aim is not peculiar to social scientists. Even a child crying and screaming has a motive and is acting to get something he wants. Businessmen also act to get things they want. They understand the science

of human action and in dealing with their fellowmen they act on that understanding every day, especially in planning for the future.

This epistemological interpretation of the experience of understanding is not the invention of a new method. It is only the discovery of knowledge everybody has been using since time began. Economist Philip H. Wicksteed [1844–1927], who published *The Common Sense of Political Economy*, chose for his motto a quotation from Goethe: *Ein jeder lebt's, nicht vielen ist's bekannt.* ("We are all doing it; very few of us understand what we are doing.")

According to the French philosopher Henri Bergson [1859–1941], understanding, *l'intelligence sympathique,* is the basis of the historical sciences. The historian collects his materials to assist his interpretation just as a policeman seeks the facts to enable him to reach a decision in court. The historian, the judge, the entrepreneur, all begin work when they have collected as much information as possible.

Auguste Comte, who contributed nothing to the development of the natural sciences, described what he believed to be the task of all sciences: he said that to be able to forecast and to act it was necessary to know. The natural sciences give us definite methods for accomplishing this. With the aid of the various branches of physics, chemistry, and so on, mechanics are able to design buildings and machines and to forecast the results of their operations. If a bridge collapses, it will be recognized that an error was made. In human action, no such definite error may be recognized, and this Comte considered a failing.

Auguste Comte considered history to be non-scientific and consequently valueless. In his mind, there was a certain hierarchy of the various sciences. According to him, scientific study began with the simplest science and progressed to the more complicated; the most complicated science was still to be developed. Comte said history was the raw material out of which this complicated study was to develop. This new study was to be a science of laws, equivalent to the laws of mechanics developed by scientists. He called this new science "sociology." His new word "sociology," has had enormous success; people in all parts of the world now study and write about sociology.

Comte knew very well that a general science of human action had been developed during the previous hundred years—the science of economics, political economy. But Comte didn't like its conclusions; he wasn't in a position to refute them, nor to refute the basic laws from which

they were derived. So he ignored them. This hostility or ignorance was also displayed by the sociologists who followed Comte.

Comte had in mind the development of scientific laws. He blamed history for dealing only with individual instances, with events that happened in a definite period of history and in a specific geographical environment. History did not deal with things done by men in general, Comte said, but with things done by individuals. But sociologists have not done what Comte said they should; they have not developed general knowledge. What they have done is just what Comte considered worthless, they have dealt with individual events and not with generalities. For instance, a sociological report was published on "Leisure in Westchester." Sociologists have also studied juvenile delinquency, methods of punishment, forms of property, and so on. They have written an enormous amount of material about the customs of primitive people. True, this literature does not deal with kings or wars; it deals principally with the "common man." But still it doesn't deal with scientific laws; it deals with historical facts, with historical investigations of what happened at one spot at a certain time. Such sociological studies are valuable, however, precisely *because* they deal with historical investigations, investigations of various aspects of human everyday life often neglected by other historians.

Comte's program is self-contradictory *because no general laws can be determined from the study of history.* Observations of history are always complex phenomena, interconnected in such a way that it is impossible to assign to specific causes, with unquestioned accuracy, a certain part of the final result. Therefore, the method of the historian has nothing in common with the methods of the natural scientist.

The program of Auguste Comte to develop scientific laws from history has never been realized. So-called "sociology" is either history or psychology. By psychology I do not mean the natural sciences of perception. I mean the literary psychology described by the philosopher George Santayana [1863–1952] as the science of the understanding of historical facts, human evaluations dealing with human strivings.

Max Weber [1864–1920] called himself a sociologist, but he was a great historian. His book *Gesammelte Aufsätze zur Religionssoziologie* (Sociology of the Great Religions) deals in the first part, "The Protestant Ethic and the Spirit of Capitalism," with the origin of capitalism. He attributed the development of capitalism to Calvinism and he wrote very interestingly about it. But whether his theory can be logically supported is another question.

One essay on "the town"—which has not been translated into English[1]—aimed at treating the city or town as such, at trying to give ideas about the town in general. He was very explicit in one regard, however, namely in maintaining that this approach was more valuable than dealing with the history of one town at a specific time. As a matter of fact, the situation may be the very opposite; it may be that the more general historical information is, the less material of value it contains.

With respect to the future, we must form certain opinions about the understanding of future events. The statesman, the entrepreneur, and, to a certain extent, everyone is in the same position. Each of us must deal with uncertain future conditions that cannot be anticipated. The statesman, the politician, the entrepreneur, and so on, are, so to speak, "historians of the future."

There exist in nature constant quantitative relationships—specific weights, and so on, which may be established in the laboratory. Thus we are in a position to measure and assign quantities of magnitudes to various physical objects. With the advance of the natural sciences, their study has become more and more quantitative—viz., the development of quantitative from qualitative chemistry. As Comte said, "Science is measurement."

In the field of human action, however, especially in the field of economics, there are no such constant relationships between magnitudes. Opinions to the contrary have been maintained, however, and even today many people fail to see that accurate quantitative explanations in the field of economics are impossible. In the field of human action, we can make explanations only with specific reference to individual cases.

Take the French Revolution, for instance. Historians search for explanations of the factors which brought it about. Many factors cooperated. They assign values to each factor—the financial situation, the queen, her influence on the weak king, and so on. All may be suggested as contributing. Through the use of mental tools, historians attempt to understand the several factors and to assign to each a definite relevance. But how much each of the various factors influenced the outcome cannot be answered precisely.

In the natural sciences, the establishment of experimental facts does

1 [The first English edition, *The City*, was translated and edited by Don Martindale and Gertrud Neuwirth (Glencoe, Illinois, Free Press, 1958).—Ed.]

not depend on the judgment of individuals. Nor on the idiosyncrasies, or individuality, of the specific scientist. A judgment in the field of human action is colored by the personality of the man doing the understanding and offering the explanation. I do not speak of biased persons, nor of those who are politically partial, nor of persons who attempt to falsify facts. I refer only to those who are personally sincere. I do not refer to differences due to developments in other sciences that affect historical facts. I do not refer to changes in knowledge which affect historical interpretations. Nor am I concerned with differences influencing men due to scientific, philosophical, or theological points of view. I am dealing only with how two historians, who agree in every other regard, may nevertheless have different opinions, for instance, as to the relevance of the factors which brought about the French Revolution. The same unanimity will not be attained in the field of human action as there will be, for instance, with respect to the atomic weight of a certain metal. And with regard to the understanding of the future operations of an entrepreneur or a politician, only later events will prove whether certain prognostications based on their evaluations were, or were not, correct.

There are two functions involved in understanding: to establish the values, the judgments of people, their aims, their goals; and to establish the methods which they use to attain their ends. The relevance of the various factors and the way in which they influence results can only be matters of value judgments. In a discussion of the Crusades, for instance, it would appear that the principal causes were religious. But there were other causes. For example, Venice profited by establishing her commercial supremacy. It is the historian's task to decide the relevance of the various factors involved in a course of events.

The historical school of economics wanted to apply to economics the same general rules that Comte aimed at in sociology. There were people who recommended substituting something else for history—a science of laws derived from experience in the same way physics acquires knowledge in the laboratory. It was also held that the historical method was the only method for dealing with problems in the field of human action.

In the late eighteenth century, some reformers wanted to revise the existing system of laws. They pointed to the lack of success and shortcomings of the existing system. They wanted government to substitute new codes for old laws. They recommended reforms in conformity with "natural law." The idea developed that laws cannot be written, that they

originate in the nature of individuals. This theory was personified by Britain's Edmund Burke [1729–1797], who took the side of the colonies and who later became a radical opponent of the French Revolution. In Germany, the Prussian jurist Friedrich Karl von Savigny [1779–1861] was the advocate of this mode of thinking. With reference to the soul of the people, this group of reactionaries agreed with the school of Burke. This program was executed to some extent, and sometimes very well, in many European countries—Prussia, France, Austria, and finally in 1900 in the German Reich. In time opposition developed to this desire to write new laws. Yet these groups were the forerunners of the present-day world.

The school of the historical method says that if you want to study a problem, you must study its history. There are no general laws. Historical investigation is the study of the problem as it exists. One must first know the facts. To study free trade or protection, you can only study the history of its development. This is the opposite approach from that advocated by Comte.

All this is not to disparage history. To say that history is not theory, nor theory history, disparages neither history nor theory. It is only necessary to point out the difference. If a historian studies a problem he discovers that there are certain trends in history that prevailed in the past. But nothing can be said as to the future.

Men are individuals and, therefore, unpredictable. Mathematical laws of probability tell us nothing about any specific case. Nor does mass psychology tell us anything but that crowds are made up of individuals. They are not homogeneous masses. As a result of the study of masses of people and crowds it has been learned that a small change can bring about important and far-reaching results. For example, if someone yells "Fire!" in a crowded hall, the results are different from what they would have been in a small group. Also in a crowd, the prestige of the police and the threat of the penal code and of the penal courts are less powerful. But if we can't deal with individuals, we can't deal with masses.

If a historian establishes that a trend existed, it doesn't mean that the trend is good or bad. The establishment of a trend and its evaluation are two different things. Some historians have said that what is in agreement with the trends of evolution is "good," even moral. But the fact that there is an evolutionary trend today in the United States toward more divorces than formerly, or the fact that there is a trend toward increased literacy, for instance, doesn't make either trend "good," just because it is evolutionary.

3RD LECTURE

Acting Man and Economics

PEOPLE GENERALLY BELIEVE that economics is of interest only to businessmen, bankers, and the like and that there is a separate economics for every group, segment of society, or country. As economics is the latest science to have been developed, it is no wonder that there are many erroneous ideas about the meaning and content of this branch of knowledge.

It would take hours to point out how common misunderstandings developed, which writers were responsible, and how political conditions contributed. It is more important to enumerate the misunderstandings and discuss the consequences of their acceptance by the public.

This first misunderstanding is the belief that economics does not deal with the way men really live and act, but with a specter created by economics, a phantom that has no counterpart in real life. The criticism is made that real man is different from the specter of the "economic man."

Once this first misunderstanding is removed, a second misunderstanding arises—the belief that economics supposes that people are driven by one ambition and intention only—to improve their material conditions and their own well-being. Critics of this belief say that not all men are egoistic.

A third misunderstanding is that economics assumes all men to be reasonable, rational, and guided by reason only, while in fact, the critics maintain, people may be guided by "irrational" forces.

These three misunderstandings are based on entirely false assumptions. Economics does not suppose that economic man is different from what

man is in everyday life. *The only supposition of economics is that there are conditions in the world with regard to which man is not neutral, and that he wants to change the situation by purposeful action.* So far as man is neutral, indifferent, content, he takes no action, he does not act. But when a man distinguishes between states of various affairs and sees an opportunity to improve conditions from his point of view, he acts.

Action is the search for improvement of conditions from the point of view of the personal value judgments of the individual concerned. This does not mean improvement from a metaphysical view, nor from God's point of view. Man's aim is to substitute what he considers a better state of affairs for a less satisfactory one. He strives for the substitution of a more satisfactory state of affairs in place of a less satisfactory state of affairs. And in the satisfaction of this desire, he becomes happier than he was before. This implies nothing with reference to the content of the action, nor whether he acts for egoistic or altruistic reasons.

To eliminate the misunderstanding that arises when a distinction is attempted between "rationalism" and "irrationalism," it must be realized that what man does consciously is done under the influence of some force or power which we call reason. Any action aimed at a definite goal is in this sense "rational." The popular distinction between "rational" and "irrational" is entirely without meaning. Examples of "irrationalism" cited are patriotism or the purchase of a new coat or a symphony ticket when something else might have appeared a more sensible action. The theoretical science of human action presupposes only one thing—that there is *action,* i.e., the conscious striving of individuals to remove uneasiness and to substitute a more satisfactory state of affairs for one that is less satisfactory. No judgment of value is made as to the reason or content of the action. Economics is neutral. Economics deals with the results of value judgments, but economics itself is neutral.

Nor is there any sense in trying to distinguish between "economic" and "non-economic" actions. Some actions deal with the preservation of man's own vital senses and necessities—food, shelter, and so on. Others are considered to be driven by "higher" motivations. But the value placed on these various goals vary from man to man, and differ for the same man from time to time. Economics deals merely with the action; it is the task of history to describe the differences in goals.

Our knowledge of economic laws is derived from reason and cannot be learned from historical experience because historical experience is always complex and cannot be studied as in a laboratory experiment. *The*

source of economic facts is man's own reason, i.e., which we call in epistemology *a priori* knowledge, what one knows already; *a priori* knowledge is distinguished from *a posteriori* knowledge, knowledge which is derived from experience.

Regarding *a priori* knowledge, the English philosopher John Locke [1632–1704] developed the theory that the human mind is born a blank slate on which experience writes. He said there was no such thing as inherent knowledge. Gottfried Wilhelm von Leibniz [1646–1716], a German philosopher and mathematician, made an exception in the case of the intellect itself. According to Leibniz, experience does not write on empty white pages in the human mind; there is a mental apparatus present in the human mind, a mental apparatus that does not exist in the minds of animals, which makes it possible for men to convert experience into human knowledge.

I am not going to enter into the argument between "rationalism" and "empiricism," the distinction between experience and knowledge, which the British philosopher and economist John Stuart Mill [1806–1873] called *a prioristic* knowledge. However, even Mill and the American pragmatists believed that *a prioristic* knowledge comes in some way from experience.

The way in which economic knowledge, economic theory, and so on relate to economic history and everyday life is the same as the relation of logic and mathematics to our grasp of the natural sciences. Therefore, we can eliminate this anti-egoism and accept the fact that the teachings of economic theory are derived from reason. Logic and mathematics are derived in a similar way from reason; there is no such thing as experiment and laboratory research in the field of mathematics. According to one mathematician, the only equipment a mathematician needs is a pencil, a piece of paper, and a wastebasket—his tools are mental.

But, we may ask, how is it possible for mathematics, which is something developed purely from the human mind without reference to the external world and reality, to be used for a grasp of the physical universe that exists and operates outside of our mind? Answers to this question have been offered by the French mathematician Henri Poincaré [1854–1912] and physicist Albert Einstein [1879–1955]. Economists can ask the same question about economics. How is it possible that something developed exclusively from our own reason, from our own mind, while sitting in an armchair, can be used for a grasp of what is taking place on the market and in the world?

The activities of every individual—all actions—stem from reason, the same source from which come our theories. Man's actions on the market, in the government, at work, at leisure, in buying and selling, are all guided by reason, guided by choice between what a person prefers as against what he does not prefer. Reason is the method by which a solution (whether good or bad) is reached. *Every action can be called an exchange insofar as it means substituting one state of affairs for another.* Hopefully the actor is substituting a situation he prefers for one which he likes less.

The starting points for the natural sciences are the various facts established by experiment. From these facts, theories are built to more and more abstractions, to more and more generalities. Final theories are so abstract that they are practically inaccessible to the general multitude. That doesn't make them less valuable; it is enough that they are accessible to the few scientists.

In an *a prioristic* science, we start with a general supposition—*action is taken to substitute one state of affairs for another.* This theory—meaningless to many—leads to other ideas that become more and more understandable and less abstract.

Natural sciences progress from the less general to the more general; economics proceeds in the opposite direction. Natural sciences are in a position to establish constant relations of magnitude. In the field of human action, no such constant relations prevail, so there is no opportunity for measurement. The value judgments which spur men to act, which lead to prices and market activity, do not measure; they establish distinctions of degree; they grade. They do not say "A" is equal to, or is more or less than "B." They say, "I prefer A to B." They don't establish judgments. This has been misunderstood for 2000 years. Even today there are many persons, even eminent philosophers, who misunderstand this completely. It is from the system of values and preferences that the price system of the market arises.

Aristotle wrote, among other things, about the various attributes of men and women. He was often mistaken. Had he asked Mrs. Aristotle about women, he would have found he was mistaken in some respects; he would have learned differently. He was also mistaken in stating that if two things were to be exchanged on the market, they must have something in common, that they were being exchanged because they were equal. Now if they were equal, why was it necessary to exchange them? If you have a dime and I have a dime, we don't exchange them because they are the

same. It follows, therefore, that if there is an exchange, there must be some *inequality* in the items being traded, not equality.

Karl Marx [1818–1883] based his theory of value on this fallacy. In *Capital and Interest,* by Eugen von Böhm-Bawerk [1851–1914], see Chapter XII dealing with Marx ("The Exploitation Theory" in Volume I, *History and Critique of Interest Theories*). Long after Marx, Henri Bergson, in a much-admired book about the two sources of morals in religion, accepted the same fallacy—if two things are exchanged on the market they must be equal in some way. But things that are "equal" are not exchanged; exchanges take place only because things are *unequal.* You take the trouble of going to the market because you value the loaf of bread more highly than the money you give for it. People exchange things because at that time they prefer other things to money. An exchange *never* occurs with the *intention* of a loss. The acting man is never pessimistic because his action is inspired by the idea that conditions can be improved.

The aim of action is to substitute a state of affairs better suiting the men taking the action than the previous situation. The value of any change in their situation is called a "gain" if it is positive, a "loss" if it is negative. This value is purely psychic, it cannot be measured. You can say only that it is greater or less. It becomes measurable only insofar as things are exchanged on the market against money. As far as the action itself is concerned, it has no mathematical value.

But, you say, this contradicts our daily experience. Yes, because our social environment makes calculations possible insofar as things are exchanged for a common medium of exchange, money. When things are exchanged against money, it is possible to use monetary terms for economic calculations, but only when three conditions are filled:

1. There must be private ownership, not only of the products, but also of the means of production;
2. There must be division of labor and, therefore, production for the needs of others;
3. There must be indirect exchange in the terms of a common denominator.

By and large, given these three conditions some mathematical values may be established, although not precisely. These measurements are not exact because they deal with what took place yesterday, historically. Business financial statements may look precise, but even the money value of an inventory entered at "so many dollars" is a speculative value of future

anticipations; the value credited to equipment and other assets also is speculative. The real problem of inflation is that it falsifies these calculations and brings about tragic problems.

Monetary calculations do not necessarily exist in all kinds of organizations or societies. They did not exist when economics began. The earliest humans acted; humans have always acted; but it was thousands of years before the evolution of the division of labor and of a financial apparatus made monetary calculations possible. Monetary calculations developed step by step during the Middle Ages. In their early development they lacked many features we think of today as necessary. (In a socialist system, these conditions would again disappear and make such calculations and measurements impossible.)

The quantitative nature of the natural sciences enables mechanics to make plans and build bridges. If you know what must be built, technology based on the knowledge of the natural sciences is sufficient. The questions are, however: What should be constructed? What should be done? Technologists cannot answer these questions.

In life the materials of production are scarce. No matter what we do there will always be other projects for which the necessary factors of production cannot be spared. There will always be other urgent demands. This is the factor that businessmen take into account in calculating loss and success. When a businessman decides against a certain project because the cost is too high, it means the public is not prepared to pay the price to use raw materials in that manner. Use is made of the available factors of production for the realization of the greatest number of those projects that satisfy the most urgent needs without wasting factors of production by withdrawing them from more urgent to less urgent employment.

To establish this it is necessary to be in a position to compare the outlays of various factors of production. For example, let it be assumed that it is necessary to build a railroad between two towns—A and B. Let us assume that there is a mountain between A and B. There are three possibilities—to go over, through, or around the mountain. A common denominator is necessary to calculate the comparative value. But this can give only a picture of the monetary situation; it is not a measurement. It is an evaluation in the light of present-day needs and situations. Tomorrow conditions will be different. The success or failure of every business project depends upon its success in anticipating future possibilities.

The problem with trying to develop a quantitative science of economics is that many persons imagine that theoretical economics must

follow the evolution of other branches of science. The natural sciences developed from being qualitative to being quantitative in nature and many people are inclined to believe that the same trend must take place in economics also. However, there are no constant relationships in economics, so no measurement is possible. And without measurement, the quantitative development of economics cannot take place. Quantitative facts in economics belong to economic history—not to economic theory.

A book titled *Measurement of the Elasticity of Demand* was reviewed recently by a man now in the U. S. Senate, Paul Douglas [1892–1976], who may even be hoping for higher political office sometime. Douglas said economics should become an exact science with fixed values like atomic weights in chemistry. But this book itself does not refer to fixed values; it refers to the economic history of one definite period of time in one particular country, the United States. The results would have been different if another period of time or if another country had been considered. Within the framework of the universe in which we operate, atomic weights do not change from one period of time or from one country to another. On the other hand, economic values and economic quantities do change from time to time and from place to place.

Economics is the theory of human action. It is a historical fact of great importance, for example, that the usefulness of the potato was discovered by the natives of Mexico, brought to Europe by a British gentleman, and that its use spread all over the world. This historical fact has had important effects on Ireland, for instance, but from the point of view of economic theory it was just an accident.

When you introduce figures into economics you are no longer in the field of economic theory, but in the field of economic history. Economic history is also, of course, a very important field. Statistics in the field of human action is a method of historical study. Statistics give a description of a fact, but they cannot prove any more than that fact. (It is true that some statisticians are "swindlers" and, as a matter of fact, some statisticians in the government were probably appointed merely for that purpose.)

Some people may misinterpret these statements and conclude that the purpose of economics, being a purely *a prioristic* science, is to develop a program for a future science, and that economics is a theory practiced only by "armchair gentlemen." Both these statements are wrong. Economics is not a program for a science that doesn't yet exist. And it is not a science merely for purists. Therefore, we must reject the ideas of some people that one must learn history to study human action. History is important. But

you cannot deal with present-day conditions by studying the past. Conditions change.

As an example of what I mean: The National Bureau of Economic Research published a report on the subject of installment selling which appeared on the eve of World War II, on the eve of inflation, and on the eve of government credit restrictions. At the moment when the study was made, it was already "dead"; it dealt with matters that were already past. I don't mean to say that it was useless. With good brains one can learn a lot from it. But don't forget it is not economics—it is economic history. What they were really studying was the economic history of the most recent past.

Darwin realized this too. He saw that in studying animals, the animal was killed at the moment when it was dissected for study, so that one could never actually study the animal—one can never study life itself.

The same is true of economics. One cannot describe the present economic system—one can only describe the past. One cannot predict about the future as a result of studying the past. Very often economic historians teach history under the label of "economics." Even though you know everything about the past, you know nothing about the future.

4TH LECTURE

Marxism, Socialism, and Pseudo-Science

TODAY I WILL DEAL WITH SOME OF THE ASPECTS of the theories of Karl Marx. I want to contribute a little bit to the materialistic interpretation of history. First of all, I must say something about the general philosophy and history of Marx.

In general, philosophical doctrines concerning historical problems are doctrines of a very special type. They try to point out not only what history was in the past but they presume to know what the future has in store for mankind and to offer a solution for future problems. Most philosophers reject this method of thinking. For example, Immanuel Kant [1724–1804] declared that a man who tried to do this would be allocating to himself the ability to see things with the eyes of God.

Nevertheless, in the 1820s Hegel gave such a philosophical interpretation of history. According to Hegel, the driving force of the Industrial Revolution was an entity called *Geist,* i.e., spirit or mind. *Geist* has certain aims which it wants to fulfill. The evolution of the *Geist* of history has now reached its final goal. This final goal, according to Hegel, was the establishment of the kingdom of Prussia of Friedrich Wilhelm III [1770–1840], and of the Prussian Union Church. Critics of this doctrine say this would mean there would be no history in the future because evolution had reached its final end.

In the middle of the nineteenth century, Karl Marx, on his own, developed a philosophy different from that of Hegel. The driving force of Karl Marx was not *Geist* or spirit but something called the "material

productive forces." These forces push the history of mankind through various successive stages, the next to the last of which is capitalism. After capitalism comes inexorably the last stage—socialism. Therefore, according to this theory, the coming of socialism is inevitable, determined by the forces of history.

The predecessors of Marx, the historic socialists, believed that to realize socialism it was necessary to convince the majority of the people that socialism was the better, or the best system; then the people themselves would bring about the substitution. Karl Marx said nothing about the desirability of socialism; he pretended not to be speaking *in favor* of socialism. He claimed to have discovered a law of social evolution indicating that socialism was bound to come with the inexorability of a law of nature.

But is socialism better? This question had already been answered by Hegel and Comte. According to their doctrines, it was tacitly assumed that each successive stage of evolution must of necessity be "better" and "higher" than the previous stages. Therefore, to raise the question of whether or not a later evolutionary stage is better is beyond the point. It was obvious. Because socialism would be a later stage, it must of necessity be better.

Marx believed that socialism was just around the corner. After that, all history would come to an end. After that there could be no further development because once the class conflict was eliminated we would be living in a state in which no longer anything important could happen. Here is a quotation illustrating that point from Friedrich Engels [1820–1895], who considered himself not only a great economist but also a great expert on military problems:

> In the first place the weapons used have reached such a stage of perfection that further progress which would have any revolutionizing influence is no longer possible. . . . The era of evolution is therefore, in essentials, closed in this direction.[1]

Since then, today's modern weapons have all been developed.

1 [*Herr Eugen Dühring's Revolution in Science (Anti-Dühring)* [1878] by Friedrich Engels (New York: International Publishers, 1939), p. 188.]

The most important problem for the doctrine of the inevitability of socialism to explain is how a superhuman entity such as *Geist* or the "material productive forces" can force individuals to act so that a certain irresistible result must prevail. People have their own individual plans—they aim at various ends. But the inevitability-of-socialism theory maintains that whatever people do they must finally produce the results which *Geist* or the "material productive forces" wanted to have produced. Two explanations have been suggested.

One group had a very simple solution. This group maintained that people will be forced by "Führers" or supermen to go the way that *Geist* or the material productive forces indicate. There have always been kings and dictators who have assigned to themselves this superhuman mission. So Stalins, Hitlers, and Mussolinis are elected by history; those who don't obey their commands must be liquidated because they are against "historical evolution."

This was not Marx's idea. The Marxian doctrine was based on the much-discussed "economic dialectic historical materialism." Materialism is one of the ways in which people try to solve one of the most fundamental and insoluble problems, the relation between the functions of the individual's soul or mind, on the one hand, and the functions of the body, on the other. Precisely what this relation is remains controversial. There is no doubt that there is some connection, and many attempts have been made to explain it. However, our only interest in such a materialistic explanation at the moment is because of its relation to Karl Marx's theory.

The materialistic philosopher says that all mental functions of men are simply produced by their bodily organs—by their physical brains. Some eighteenth-century philosophers suggested this idea. In the nineteenth century it was expressed more crudely by some of Marx's contemporaries, among them the German philosopher Ludwig Andreas Feuerbach [1804–1870], who said bluntly, "Man is what he eats." This is interesting, but somewhat difficult to accept. Chemically, the secretion of the organs of all normal men is the same. Insofar as they are not, insofar as there are irregularities, these variations indicate a pathological condition and these irregularities are the same for all men in the same pathological condition. Ideas and thoughts, however, are different. Two boys may take the same exam, but their answers to the same questions will be different. The Italian poet Dante wrote beautiful words, while others may have difficulty writing anything at all. Therefore, there is something "fishy" about this doctrine.

Marx rejected this type of materialism, saying these materialistic

philosophers were weak in dealing with social problems. In spite of the fact that superficial knowledge of Marx's own brand of materialism requires very little time, it is not very well known. His particular brand of materialism is expressed on a very few pages of his *Critique of Political Economy*, the original draft for the first chapter of *Das Kapital*:

> In the social production of their subsistence men enter into determined and necessary relations with each other which are independent of their wills—production-relations which correspond to a definite stage of development of their material productive forces.[2]

The material productive forces produce, independently of the will of the people, definite legal and institutional systems called "production-relations." Production-relations are the necessary consequences of the material productive forces.

Over and above the production-relations there is a super-structure which includes everything ideological—art, literature, science, religion, and so on. These super-structures are the necessary products of the existing production-relations. The production-relations are, in turn, the necessary consequences of the existing material productive forces, which are the real thing. The material productive forces alone have an individual effect. When the material productive forces change, they inevitably bring about, independently of the will of man, corresponding changes in the production-relations of the social organ, of society. They also bring about changes in the super-structure. Therefore, the important question is: What are the material productive forces?

Here we are faced with Marx's peculiar technique of not giving definitions of the terms he uses. However, his occasional examples are helpful. Most important is the example which appears in *The Poverty of Philosophy* (1847). The hand mill gives you "feudal society"; the steam mill gives you "industrial society." This means that the material productive forces are the tools and machines. It is the tools and machines that are the real things. The tools and machines change; they have a history of their own; they produce first of all the production-relations and the social structure, and above the social structure they produce the super-

2 [*Capital, the Communist Manifesto and other Writings* by Karl Marx, edited with an introduction by Max Eastman (New York: The Modern Library, 1932), p. 10.]

structure—the literature, religion, and so forth. Other instances lead us to the same conclusions, that what Marx meant by the "material productive forces" were the tools and machines.

But two important questions arise. Tools and machines do not appear in the universe independent of the human mind. They are products of human thought and ideas—they are products of the human mind. Secondly, these tools and machines can only be introduced into practice when the social conditions make it possible—there must first be a certain degree of division of labor in order to apply and to use machines. Without the division of labor, machinery, the product of ideas is useless. Is this really materialism? Thus the evolution of Marx's ideological factors—the source of ideas, the basic material productive forces—is traced back to products which are themselves the result of the human mind. Therefore, the whole scheme is unsatisfactory.

Marx wanted to show how new ideas originated. He attacked the theories of the eighteenth century, especially those of Scottish historian and philosopher David Hume [1711–1776], that ideas that are the important thing, that changing ideas result in changing conditions. Marx said that ideas are nothing but the necessary outcomes of material factors, products of the material productive forces. But we see that the material productive forces are themselves the products of ideas. Marx's thinking moves in a circle.

There were others besides Marx who attached enormous importance to inventions and improvements in machines. A little later in the 1870s, Leopold von Ranke [1795–1886] declared that the history of technology is the most important aspect of human history; everything is continued by technology. Marx went farther in saying that everything really and literally depends on changes in technology. But he couldn't explain everything from the materialistic point of view because tools and machines are themselves products of the human soul.

When Marx died, his friend and collaborator, Friedrich Engels, addressed his friends at the grave. In this speech he tried to condense into a short statement what he considered the great immortal ideas of Marx. This speech contains a slightly new interpretation of Karl Marx. Engels declared that "Like Darwin, who discovered the law of evolution of organic nature, Marx discovered the law of mankind's historical evolution, i.e., the simple fact, hitherto hidden beneath ideological overgrowths, that men must first of all eat, drink, have shelter and clothing before they can pursue politics, science, art, religion and the like. . . ." This, said Engels,

had been unknown before Marx discovered it. But it is obvious; nobody has ever denied it. As a matter of fact, there is an old Latin dictum or saying of the early Middle Ages: "First you must live, then you can be a philosopher."

It was a wonderful trick of Engels to give this interpretation to Marx because since then, whenever anyone tries to contradict Marx's theory, he is asked whether he denies that one must first eat and drink before one can write. It is obvious that one must. So you are forced to accept the basis of the Marxian theory.

Marx continues. Society is divided into classes and every member of a class is bound by the laws of history to think according to his class interests. The class allegiance, not only in the present state of society but also in preceding stages when the classes developed, determines the content of a person's ideas. A person thinks in a certain way because he is a member of a definite class. And as all class members think according to their own class interest, the result is that the interests of those classes which history has selected must finally triumph. Marx's idea is that the class, not the individual, thinks.

Classes do not create themselves. We make classes by classifying. If a classification is correct and logical, then the classification cannot be attacked. Marx classified people and assumed that there existed an irreconcilable conflict of interests among the several classes. The question is, does such a conflict exist? Marx never proved this. He first presented the theory of classes in the *Communist Manifesto* of 1848. Later he published lots of other books. But he never told us what a "class" was; he only explained what classes were not.

In one of the volumes of *Das Kapital,* published by Engels after Marx's death, there is a chapter titled "Classes." Here Marx starts out by telling what classes are not. Then the manuscript ends. A note by Engels says the work was never finished. We could feel very sad if we did not know that Marx's writing was not interrupted by his death; he stopped writing these volumes many years before.

Marx gives examples of class conflict, but they all refer to conditions of status in a caste society, when one is born into a certain caste—nobility, bourgeoisie, serfdom, and so on. Under such circumstances, there *is* a conflict of interests. Anyone born a member of a definite caste has only as much right and privilege as his father. And then it is correct to say that there are class conflicts. But a society in which there is equality under law

and in which everybody is free to do what he wants—in such a society there are no rigid "classes" and no irreconcilable "class" interests.

It follows, therefore, that to talk of the "bourgeoisie" implies that one group has special interests over and above those of the multitudes. This is the philosophy implicit in the U.S. policy that we should grant subsidies to farmers, or special privileges to labor, provide assistance to the "Ruritanians" to keep them from going Communist, and so on. If they want to go Communist, that is best for them. We are living in a world dominated by this "class" philosophy. Referring to the bourgeoisie assumes the Marxian theory of classes.

Even if we assume Marx's other theses, it is difficult to accept his class argument. Marx admits in the *Communist Manifesto* that there are people who are class-conscious and those who are not, that the interests of some individual are opposed to the interests of their "class." Why should an individual think according to the interest of his class if the class interests are different from his own interests? It is said that the workers in the United States are extremely backward in the development of class consciousness. If a lack of class consciousness can exist, how is it possible to say there is such a thing as a class interest?

There are also differences of opinion among various persons as to what the interests of the class really are. The question is, which is right? The Marxians say, "It is very easy to know. If a member of the class thinks differently, he is a class-traitor, a social-traitor. If another man, not a member of the class, thinks differently, there is no need for an explanation." The difficulty with this is that there are in fact some class members who don't think along the lines prescribed by their "class interests."

Another difficulty is that Karl Marx himself, who presumed to speak for the proletarians, was not a proletarian. He was the son of a well-to-do lawyer; he married the daughter of a Prussian *Junker*; and his brother-in-law was chief of the Prussian police. Then too, his associate, Friedrich Engels, was not a proletarian; he was the son of a manufacturer and he was himself a manufacturer. Their answer to this criticism is:

> Finally, in times when the class-struggle nears the decisive hour, the process of dissolution going on within the ruling class—in fact, within the whole range of an old society—assumes such a violent, glaring character that a small section of the ruling class

cuts itself adrift and joins the revolutionary class, the class that holds the future in its hand.[3]

But Marx and Engels were not in the rear of the movement—they were in the forefront of the movement. They and other leaders of the movement were also bourgeois.

In England when the Fabian movement developed, continental socialists visiting that country to meet their eminent friends and admirers were often amazed to find that the Fabians were a very socially eminent set. At their dinners they appeared in white tie and tails and the ladies wore jewelry and all the paraphernalia of Victorian society. It is at least questionable that socialism was an outcome of the proletarian mind.

How could a man like Marx fail to realize that it is not "interests" that create ideas, but rather that ideas teach people what their "interests" are? How could he fail to see this? I believe it was because he was fully dominated by the idea that economics is merely food, clothing, and shelter. It was his idea that the starving masses were intent only upon getting food. He was fully convinced that the trend of capitalism was, inevitably, to cause impoverishment of the masses and concentration of the wealth in the hands of a small group. He was convinced that nothing could prevent this trend, and that this trend would finally bring about socialism.

Everybody knows this is not true. But, people answer, it is not true because something happened that Karl Marx could not have foreseen. He did not foresee the union movement and social legislation. But one short paper published by Marx did discuss labor unions and it said it was hopeless for them to try to improve the condition of the workers because the trend of history was in another direction. Real wages inevitably go down and down. Unions should abandon their effort for higher wages and substitute a "conservative" aim—to do away forever with the wage system. Marx was opposed to social legislation—social security and so forth—at least after the 1850s when he affirmed his belief that the material productive forces would bring about changes. If the material productive forces change, the whole structure must necessarily change, because the material productive forces can no longer develop in the old relationship. On the advice of Marx himself and, after his death, of Friedrich Engels, the German Reichstag voted *against* socialized medicine, social insurance, and

3 [Marx, op. cit., p. 331.]

labor legislation, calling them frauds to exploit the laboring classes even more than before.

> No social formation ever disappears before all the productive forces are developed for which it has room, and new higher relations of production never appear before the material conditions of their existence are matured in the womb of the old society.[4]

Therefore, it was Marx's thesis that in order to accelerate the coming of socialism, capitalism must first reach maturity. (This is comparable to the "mature capitalism" of the New Deal.) All these methods to "improve" capitalism such as social security, labor legislation, and so forth, are just petty bourgeois policies; they are detrimental to the interests of the workers because they only postpone the maturity of capitalism.

If it is true that the coming of socialism—a blessing for the workers—is independent of the will of men, if it depends exclusively on the maturity of capitalism and the development of the productive forces within capitalism, what is the use of a Socialist Party? Isn't it preposterous, according to this theory, for man, who has nothing to say as to the future, to attempt to reach a goal? The answer made to that question is that, just as a midwife is necessary to aid a mother give birth, so is the Socialist Party necessary to bring socialism into the world. Sometimes the midwife may interfere and the situation changes, but she serves a purpose.

Thus we see that Marx's attempt to show that ideas are the products of something material was not too conclusive. He demonstrated only that ideas are produced by forces which are themselves already the products of other ideas. All his theories teach is that among ideas some are more important than others. According to him, the idea that brings about the construction of a new machine, for instance, is more important than the ideas that bring about a poem or a philosophical system. The value of all these mental activities is attacked by Marx. What is the use of poetry, the value of religion, if these are merely consequences of the fact that we have certain tools of production? I wouldn't even call this theory of Marx's "materialism."

In the 1840s and the 1850s, recognized sociologists and economists

4 [Marx, op. cit., p. 11.]

devastated the teachings of the socialist authors with their criticism. But their critiques did not touch the most important problems. There was no reason for them to do so because they abolished the assertions of their socialistic contemporaries. Karl Marx realized that he couldn't answer these critiques, and his socialistic doctrines took another turn. First of all he elaborated the theory that everybody is bound by the laws of nature to think in such a way as the interests of his class force him to think. He believed that a man's theory, no matter with what it deals—whether religion, philosophy, or law—can never give us truth so long as there are classes. Class ideologies, he felt, are obviously false because of their deficiencies and biased to serve the interests of the author. Marxians, even today, believe that they have proved their thesis simply by asserting that there is no such thing as an unbiased search for truth, that man doesn't search for truth but only for practical results.

For the sake of the argument, if we accept the thesis that all mental activities are motivated by the desire for practical results, we must admit that if a man wanted results, he would aim at a theory which was correct. Pragmatists say "truth" is something that works when applied. Ludwig Boltzmann [1844–1906], a positivist philosopher, said that the proof that our physical theories are correct rests on the fact that machines constructed according to these theories operate as expected. Because people wanted to kill one another by firearms they developed the theory of ballistics. According to Marx, the theory of ballistics was not developed because people wanted to kill other people, but the theories are correct because they wanted to kill. Marx developed his theory because he wanted to say that the proletarians needn't worry about the bourgeois point of view; what the bourgeois economists said about socialism was of no concern to the workers.

The second point he developed was the theory of the inevitability of the coming of socialism because of the progressive impoverishment of the workers by the capitalists. As socialism is a later stage, Marx said, it is necessarily also a higher stage. It is, therefore, beside the point to develop plans for the future socialistic state. Critics have demolished these ideas saying they cannot work. But Marx said that we do not have to do it; the productive forces will make the plans when everything is ripe.

Marx's success was enormous. Today, many people who believe that socialism is inevitable consider themselves young Marxists and young Communists. There has been resistance to his historical materialism, but there has been little resistance to the theory of the inevitability of socialism.

The main deficiency of the present-day mentality is precisely the fact that people are rather weak in criticizing the fundamental thesis of Marxism. A book by Alexander Miller on *The Christian Significance of Karl Marx* (New York: Macmillan, 1947) recommends the use of the Christian religion to endorse not only Marxism itself but also Marxian materialism.

Marx was consistent in rejecting attempts at labor legislation. His theory was that the world must follow a certain sequence of events: (1) feudalism; (2) capitalism; and (3) socialism. Because it was incompatible with his theory, he rejected the theory that one stage could be skipped over. However, when Marx died, Engels found among his belongings a note by Marx on a scrap of paper suggesting that this might be possible. Evidently Marx had scribbled this note one night—in the morning he had thought better of it, realizing that if he agreed to this it would destroy his basic theory. Engels copied the note in his own handwriting and sent it to a woman in Russia who had won some fame because she had killed the police commissar and had been acquitted—such things happened in Russia then. She published it in the 1880s. The Bolsheviks thought this was a wonderful idea—they knew Russia was backward and seized upon this as grounds for believing they wouldn't have to go through capitalism before attaining socialism, but could skip over that stage.

The importance of Marx is that he branded the doctrines of other humanists as ideologies, false theories which precisely on account of their incorrectness are useful to the class from which they emanate. As an economist Marx was completely dominated by the doctrines of the British classical economists. They developed the important system of political economy, but they failed to solve one fundamental problem—the paradox of value. Their theory seems obvious—people value external things and services because of their utility, because these things can bring about certain useful services—the more useful the service, the greater the value. But they couldn't explain why one unit weight of gold, which is less useful than iron, is exchanged against a number of such units of iron.

In 1870, the solution to this paradox was discovered independently three different times by three different persons—William Stanley Jevons [1835–1882] in England, Carl Menger [1840–1921] in Austria-Hungary, and Léon Walras [1834–1910] in Switzerland. These three men recognized that only a definite limited quantity of something is traded in any particular exchange. People don't exchange the total available supply, for instance, of iron or gold. If a man gives several units of iron for one of gold,

he doesn't behave as if he were exchanging the entire stock of iron against the entire stock of gold. The greater the quantity available, the smaller the value per unit, the smaller the satisfaction per unit. This was the marginal-utility theory.

The theory of the classical economists was responsible for the fact that values weren't traced to the ultimate consumer. This explains why so much value was attached to the theory of buying cheap and selling dear and it led to the misunderstanding of the specter of "the economic man." This theory dealt only with the businessman, not with the consumer. That would have required starting from the utility, which was not easy for the ordinary person to understand. The important fact is that the two great socialists of the nineteenth century, the radical revolutionary socialist Marx and the parlor socialist, philosopher, and economist John Stuart Mill [1806–1873], were so convinced of the classical theory of value that they never had any doubts about it. That theory of value had already been criticized among others by Ferdinand Lassalle [1825–1864], who had more influence in his day than did Marx. But this classical theory, as perfected by Ricardo, was adopted by Marx. And Mill, in his *Principles of Political Economy*, published in 1848, stated that the theory of value is solved for all time to come—coming generations could make no further improvement on it.

Marx called the system of the classical economics a bourgeois ideology. Yet what he developed as economic theory was nothing but the classical system shaped a little bit differently and expressed in slightly different words. Marx's addition to economics is of very little importance. As an economist he more or less repeated what he had heard from others—sometimes calling them idiots, sycophants, and so on—but never deviating very far from their teachings.

Marx explains history as the result of economic class interests. Every situation contains groups who are profiting or suffering in the short run, and it is to these interests that Marx points. For example, if there were a plague or an epidemic, the drug manufacturers and the doctors would profit. Long-run interests are not so obvious and can be determined only by ideas.

5TH LECTURE

Capitalism and Human Progress

I WANT TO START TONIGHT WITH THE RELATION between economics and human practical life, and the consequences of the development of the theory of economics.

Kipling said, "East is East, and West is West, and never the twain shall meet." Differences between the East and the West have certainly existed for thousands of years. The East never developed the idea of scientific research—the search for knowledge and truth for its own sake—which the Greeks gave to civilization. A second achievement of the Greeks, which has always been foreign to the East, is the idea of political liberty of government—of political responsibility of the individual citizen. These ideas, widely accepted in the West, never found counterparts in the East. Even today, only a small group of Eastern intellectuals follow these ideas. Nevertheless, the world was more or less one world, in spite of these ideas, until about 250 years ago.

Social relations and living conditions were more or less the same all over the world until 250 years ago. The average standard of living varied little between East and West. Modern methods of production and standards of consumption, technological knowledge, and equality under the law were unknown. Today we would consider most unsatisfactory the conditions that prevailed then. Aside from its political meaning, Wendell Willkie's word, "One World," was more applicable then than now.

The general improvement in political tranquility, which had reached a certain degree about 250 years ago, contributed to an increase in popula-

tion. This additional population was too much for the social system of those ages. The countries where political conditions were most favorable became infested with robbers, thieves, and murderers—people for whom there was no place under the existing economic situation.

Then something occurred in Europe—first in western Europe, Great Britain, and the Netherlands—which spread over the rest of the Western world. It was this movement that led to considerable differences between the East and the West. This movement is called by historians the Industrial Revolution. Radical changes were brought about by preceding radical intellectual changes, that is, by the intellectual movement that produced economics as an autonomous branch of human knowledge. These radical changes multiplied population figures and changed the face of the world.

Some of these ideas had been developing during earlier generations. For instance, Gresham's law, the "law" of Sir Thomas Gresham [1519?–1579] which points out that a legally overvalued (bad) money ends up driving a legally undervalued (good) money out of circulation. This regularity in the field of money had been noted earlier by the Greek comic dramatist Aristophanes [448?–?380 B.C.] in *The Frogs* and by the French bishop Nicolas Oresme [1320?–1382]. However, there had been no realization that similar regularity existed also in relation to the concatenation and sequence of phenomena in the marketplace. The recognition of regularity in the broader field of market activities was an achievement of the human mind, a mental accomplishment. As a result of this new knowledge of regularity in the marketplace, people began to look on all productive activities from a different viewpoint.

The question has been raised as to why the ancient Greeks, for example, whose knowledge of science was so far advanced, did not make practical use of their discoveries. It has been said that they had the scientific knowledge to develop railroads, but they didn't. Why not? Their progress was handicapped by certain ideas. One idea that held them back, an idea which still prevails today, is that of "technological unemployment," the idea that improved methods of production lead to unemployment. Because of this, it was considered a crime to deviate from traditional methods of production, no matter how unsatisfactory the old methods were. The idea did not occur to them that reducing the amount of labor required for the production of a certain amount of goods or items would make possible the freeing up of materials and labor for the production of other items.

The second idea that handicapped the Greeks' development was that they looked on a business deal as one-sided—the seller profits, the buyer loses. This attitude was especially important in its effect on international trade. This old superstition that foreign trade will create unemployment still prevails today. Many people still believe that the advantage to be derived from foreign trade comes from exporting, not from importing. If this were the case, it would mean that the advantage to be derived from buying a loaf of bread would come from "exporting" the money, from spending the money to obtain the bread, and not from getting the bread itself.

Because it was considered a crime to depart from traditional methods of production and trade—and any changes are necessarily always innovations—we are apt to ignore another development, a new idea heretofore unknown. We are blind to the great changes that took place, not only in production, but also in consumption. We see the mass production, but fail to see that this mass production was produced for the satisfaction of the needs of the masses. The guilds and handicraftsmen of the Middle Ages had produced for the well-to-do. Before the Industrial Revolution, and in the early days of the Industrial Revolution, there was a great trade in secondhand clothing. Clothes that were made to order for the well-to-do were bought secondhand by the poor. This trade in secondhand clothing, a really important part of the economy, disappeared as a result of the development of modern methods of production.

The Industrial Revolution started by producing for the needs of the poor, of the masses. Mass production started by producing the cheapest and the poorest things. The cotton industry was one of the early developments of the Industrial Revolution. Cotton was a poor man's material—no member of the upper or middle classes wanted cotton. The quality of mass production improved only when the conditions of the masses improved to the extent that they also became biased against cheap products. Not so long ago no lady or gentlemen would have bought factory-made shoes, or ready-made clothes. Not until 100 or 120 years ago could one even buy a ready-made shirt in Germany. All these industries have developed during the last 100 to 150 years.

As a consequence of the Industrial Revolution in the West, an enormous gulf developed, a gulf which today separates the West from the East. The East still clings to the idea that once hindered the development of capital in the Western world, the idea that one man's wealth is the cause

of the poverty of others. The concept of the "underdeveloped nations" has arisen and the idea that it is necessary to give them technological advice, i.e., "know-how." This is really ridiculous! There are lots of Indians, Chinese, and students from other countries in our universities who are very capable persons and who are acquiring know-how. And even if they weren't, many Americans would be willing to go to those countries to work and to give advice. What they really need is the capital. What is lacking is capitalism.

What is the use of economics, of theoretical economic discussions? All the achievements of the physical and chemical sciences would have remained a "dead letter," without any significance for real life if the ideas spread by the economists of the eighteenth century about the division of labor, freedom of exchange, and so on, had not paved the way for the practical application of those scientific discoveries. And yet some people today still look askance at innovations. For instance, a German professor, who was considered an eminent economic historian and was an honorary member of many societies, said in one of his last books that it was a very serious drawback that our social institutions permitted everyone the opportunity of producing an invention to put it into practical use. He believed that no harm could come from putting inventions in museums, but unless they were military inventions, that is where they should remain. (This was the basis of the *Führerprinzip*—the idea that the all-knowing *Führer* should give the orders and that the *Führer* receives his orders directly from God, who is the *Führer* of the Universe.) Scientific advance may be hindered to a certain extent but, by and large, it is impossible to stop it completely.

Some people consider scientific progress "material." To aim at nothing but improvement of the material or external conditions of life—better food, clothing, homes, and so forth—they called "materialism." They said people who have such goals care only for the "mean" necessities of daily life. On the other hand, they think *they* are ethical and that they display idealism by disparaging such material improvements. But let us see.

One of the consequences of the Industrial Revolution was that the world is now populated by many more people than could have been supported before. Each individual in the capitalist countries also lives at a much higher standard of living than before. This means that the average length of life is much longer. The growth in population was not achieved by an increase in the birth rate, but by a decrease in the mortality rate,

especially of infants. Queen Anne of England, the last reigning member of the Stuarts, had seventeen children, but not a single one lived to reach adulthood. This situation had serious significance for England; it created the historical and religious problem of the Protestant succession. As further evidence of the extent of infant mortality, most of the charming children in the Habsburg families that Velásquez painted died in childhood. You may call the improvement of living standards brought about by the Industrial Revolution "materialism." But from the point of view of the parents, the improved life expectancy of their children may not have seemed merely materialistic.

Engels said people must eat before they can develop philosophical ideas. With this I can agree. The Europeans are now claiming that they are fighting the "Coca-Cola civilization," but it would be a mistake to say that capitalism has developed nothing but Coca-Cola. Capitalism has certainly led to philosophical and theological improvements also. In the light of the great scientific discoveries of the nineteenth and twentieth centuries, to say that the capitalist economy is the "Coca-Cola civilization" would not seem to be an "unbiased" statement.

Several rights and liberties developed with the Industrial Revolution—policies of economic freedom both in domestic and foreign trade, of sound money and of abstention from government interference. These are policies, not scientific truths; they are policies based on value judgments that arose because of knowledge that had been developed. We must realize the relation between knowledge and values.

It is easier to grasp this distinction in the field of medicine or chemistry. Scientists may establish the fact, for instance, that drug A is a poison, but they do not issue a value judgment on the drug. Pathology and chemistry do not say how a chemical should be used. Their task is accomplished when they determine whether it will, or will not, prolong human life. The decision whether or not to use the poison, and how, must come from somewhere else, not from the chemist or pathologist; that decision must come from a value judgment. If a doctor cannot save the life of both mother and child, a dilemma results: Whose life should be saved? The answer does not come from medical science; it must come from a judgment of value.

In the field of social relations and human conduct, science provides us with existential propositions, statements as to the consequences of certain causes. There is a fundamental difference between such statements of fact

and the judgment of value which tells us what alternative is more desirable, more preferable. A value judgment tells us what *ought* to be from the point of view of those who share the same values.

It would appear that the importance of economics for daily life is small. But that is not true. Actually economic theory is very important. In order to take the proper steps to attain a specific goal, we must first be familiar with the actual state of affairs—the existential situation. But then we need economic knowledge, economic understanding, to make decisions, to act, to make value judgments. To judge the importance of economic knowledge, consider the case of Iran. When she confiscated the property of the Anglo-Iranian Oil Company recently and nationalized the oil industry, she wanted to improve the situation of her people.[1] The question is whether or not the policy she is following will have that effect.

The classical economists introduced the term "the rightly understood interests." There are various "runs" of different lengths of time. To determine "the rightly understood interests," one must consider all possibilities because the short-run end is often different from the long-run end. One of the most popular attacks on economics is that economists take only the long run, not the short run, into consideration. But that is not true. Economists simply point out that there is a distinction between the two.

One is apt to prefer short-run interests to interests in the long run, but this doesn't mean one must consider only the long run. Governments seeking to remedy economic ills by various interventions may not destroy the capitalistic countries in the short run. Some poisons act quickly, others more slowly. Like a slow poison, government interventions may bring about consequences in the long run which are disastrous, even from the point of view of precisely those persons who wanted to resort to these measures.

John Maynard Keynes [1883–1946] said, "In the long run, we are all dead." This is my only point of agreement with Keynes. Even though this idea is correct, it means no more than does the remark of Madame de Pompadour, mistress to King Louis XV, whose role it was to console the king when his armies were threatened—"There is no reason to worry.

1 [On April 30, 1951, the Iranian Parliament under Premier Mohammed Mossadegh enacted legislation, retroactive to March 20, 1951, expropriating the property of the Anglo-Iranian Oil Company and nationalizing the industry "[f]or the happiness and prosperity of the Iranian nation and for the purpose of securing world peace."—Ed.]

'Après nous le déluge.'" Fortunately for her, Madame de Pompadour died early. But her successor as Louis XV's mistress, Madame du Barry, was not so fortunate—she survived the short run but lived to be executed in the long run.

But Keynes's ideas are unsatisfactory even from his point of view. His credit expansion theories bring about an artificial boom which eventually must turn into a depression and crisis. The unwanted consequences may appear several times during one's lifetime, not only after one's death. A man living today may have seen the depressions of 1907, 1921, 1929, 1937, and he may live to see yet another.

Economics merely states that there are both short-run and long-run consequences. One must consider both. Decisions should be made in the light of all knowledge available. Economics doesn't say, for instance, that free trade is better than protection. Economics merely points out the differences between the consequences of the two. Economics merely states that protection is not a way to improve the general standard of living. But this does not apply to cases in which a protective tariff is advocated for other reasons. For example, when the United States realized the threat to her supply lines on the eve of World War II, she could have introduced an import duty on natural rubber and subsidized synthetic rubber manufacturers. But this would then have been considered a "defense" expenditure, not a choice based on economics, and it would have been judged from the point of view of defense.

What the economist provides is not judgments of value, which no science may issue, but the information one needs to make value judgments and decisions. The valuation, the judgment, rests with the individual, with the people, and with the voters.

The idea of the neutrality of science has been criticized, especially by those who wish to elevate certain judgments of value to a higher degree, to the dignity of a rule which everybody must obey. In Germany, especially after the War of 1870, the German professors who taught the economic aspects of political science considered it regrettable that there should be tolerance, understanding, peace, and good will among the nations.

The idea of the neutrality of science (*Wertfreiheit*—freedom from value) is the most characteristic development of science. Because economic science is neutral, this does not mean that it doesn't deal with practical problems; it only means that it doesn't explain the meaning of human

action. *But it is precisely because of its neutrality that people with different evaluations are able to live peaceably together.* This is one of the most important ideas that came out of the Industrial Revolution and the development of modern science. It was an idea that was absolutely foreign to the most eminent minds of the sixteenth century. Very few persons then could have understood that people with different religions, values, and ideas, could live together in the same city, the same country, or the same world.

The peaceful exchange of ideas and the peaceful coexistence of people with various ideas were in triumphal progress at the beginning of the nineteenth century. There was then a development toward freedom and peace, especially toward intellectual freedom for ideas, toward the elimination of government cruelty in punishment and of government torture in criminal procedure, and also toward an improvement in the standard of living. People came to believe that this development toward freedom and peace was inevitable. In the nineteenth century they were fully convinced that nothing could stop this trend toward more freedom. The Manchester Chamber of Commerce in Great Britain even declared in the 1820s that the age of war was gone forever. That was the bloodless economic theory. There need be no war if there was free trade and representative government. But these same people failed to realize that a reaction had already started. A movement was developing in the opposite direction.

Among the opponents of the idea of freedom was Auguste Comte. It is this reaction against freedom that splits the world into two camps today. Paradoxically, those who support the groups that favor imprisonment, persecution for deviations, and so on, are called "progressives."

The "ethical economists" who opposed the "materialism" of the bloodless economic theory of the British, became the predecessors of what was later called Nazism. The Nazis, imitating the Marxists, would tolerate no opposition. A good German could have only German ideas; everybody should be forced by the laws of nature to think according to the "natural" interests of his race or nation. The Nazis had difficulty explaining such persons as Beethoven, Goethe, Kant, and so on, all Germans, but Germans who had un-German ideas. Now, in view of later events, we can ask whether or not these Nazi ideas, imposed on the German people ostensibly for their own good, were really so useful to them in the long run.

Some modern communists allege that they anticipated the success of Nazism. But they did not! On the contrary, not a single one foresaw it. In

Germany at the end of the 1920s and the beginning of the 1930s, the Nazi party first made its appearance. Neutral observers said, "It is true; they are getting some votes, but it is impossible for Germany to go Nazi. Look at the statistics. A majority of the Germans are workers and Marxists. They will never give their votes to the Nazis." This shows that one cannot anticipate history. One can make prognostications, but whether or not these prognostications will be correct is questionable.

A group with special interests is likely to be in the minority. Cattlemen, dairy farmers, cotton growers, wheat farmers, and so on, are all minorities with special interests. But if government intervenes, alliances may be formed among such groups, even though their interests are not identical, even though they may be in opposition to one another. The same situation exists with respect to labor—garment workers, railroad men, coal miners, and so on. In political life, the thing we have to face is not pressure groups formed because of natural common interests but pressure groups made up of government-promoted alliances of several minorities.

Privileges are of benefit only when they are granted to a minority. Under certain circumstances minorities may secure certain privileges for a time but eventually the advantages will deteriorate, especially for farmers when people begin to realize the various consequences. It is not difficult to convince the various minority groups that they are losing more on the one side than they are receiving on the other, so such alliances can be only temporary. In a representative government a minority can never secure for itself a privilege except in alliance with other groups. Only when people have true knowledge, will they reap the benefits.

Before the Nazis, Germany was called the nation of the poets and thinkers. The Nazis developed a theory of all-round protection, protection for every kind of national organization and for all national production. They did not realize that if you protect everybody to the same degree everybody wins exactly as much as a consumer as he loses on the other end as a producer. If this happened in Germany, the land of poets and thinkers, what can you expect of other countries? The consequences lead to the desire for another system, so the people vote for a government that will protect them from their own ignorance.

In the long run, every country must be ruled in agreement with the ideas of the majority. If the country's government is against the people's ideas, then sooner or later the majority will cause a revolutionary upheaval and eliminate the leaders. In "First Principles of Government," an essay by

David Hume, he states that in the long run it is opinion that makes government powerful. For this reason, representative government is good; it reflects opinion. And the next election removes the disagreement.

If the majority is dominated by bad ideas, nothing can be done about it except to try to change the bad ideas. This is the business of writers, authors, economists, and so on. Unfortunately there are many bad writers, bad authors, and bad economists. Still, there is no substitute for trying to substitute good ideas for bad ideas. In the field of state, government, and economic organizations, the consequences of a policy appear only after a very long time and when they appear they are only historical facts. Since it is difficult to ascribe them to one definite cause, changing ideas may be very difficult. Still the only way to deal with bad ideas is to try to substitute good ones.

The social philosophers and the economists of the eighteenth and early nineteenth centuries especially were imbued with the idea that progress toward better conditions and toward more freedom would go on forever. They did not anticipate the events of our age.

All we can know about the future is through the methods of historical understanding and this does not give us certainty. However, the fact that the future is uncertain and that we are free acting individuals are one and the same fact. If the future were known, then we wouldn't be men, we wouldn't be free and we wouldn't be able to make decisions and to act. We would only be ants in an anthill. There are pressures in the present world which are trying to convert men into ants, but I don't think these tendencies will succeed!

6TH LECTURE

Money and Inflation

ONE OF THE PROBLEMS WITH WHICH AN ECONOMIST MUST STRUGGLE is the fact that the terminology of business was developed prior to the development of economic theory, so that the language is not particularly appropriate for dealing with economic problems. One such case, which has resulted in real difficulty, is that of the money market.

At the end of the eighteenth century the British economists found the "money market," which was concerned with the lending of money to businesses. The terms "demand for money" and "supply of money" were already in use to signify the demand for, and supply of, *loans.* These terms were so firmly established that they could not be used for dealing with monetary problems, that is, for dealing with the demand for, and supply of, *money* as such. On the contrary economists had to point out that the rate of interest and the demand for loans on the market did not depend on the amount, or quantity, of *money* in existence. They had to point out that there was a demand for *money,* for cash money, independent of the demand for *loans.* As the stock market and the money market became more and more familiar to the people through newspaper reports, this was difficult for them to understand. Almost every newspaper used this business terminology to report on the state of the money market, i.e., the loan market.

Economists pointed out that there exists on the market a demand for money and a supply of money similar to the demand for, and supply of, any other article. It should be noted parenthetically, however, that this

demand for, and supply of, money has nothing to do with the demand for, and supply of, loans. It is significant also that while the demand for most goods is a demand for consumption, the demand for money is not a demand for consumption; the demand for money does not consume or destroy the individual piece. The demand for money *per se* is a demand to hold money, a demand for "cash holding."

Because future conditions are necessarily uncertain, people must keep a definite amount of cash on hand. Should things be certain, they could invest every bit of money for a definite time. Knowing exactly when they would need cash, they could plan to have their investments mature at that time. But because one cannot estimate exactly when money will be needed, one must keep a certain amount of cash on hand or in a checking account; one cannot lend or invest all one's cash money.

Money in circulation is the sum of all cash holdings. Concerning the history of an individual money piece, there is no money piece that is not held by somebody, i.e., no cash that does not occur in somebody's cash holding. It goes from one person's cash holding to another person's cash holding. In the case of any particular money piece, there is no instant between these two situations. There is no such thing as money that is not owned by someone and the disappearance of which in some way, for instance by fire, would not hurt the individual whose money it was.

False definitions, incorrect explanations and interpretations, of money fall into two classes, namely that money is either (1) something more than a commodity, or (2) something less than a commodity. But in reality money is neither more than, nor less than, a commodity; it is everything that a commodity is. Like any other commodity, the supply available influences its market value and like any other commodity, it is in demand because people consider it useful.

Because there is a demand for money for cash holdings, and because people are ready to part with goods to get money, the value of the object used for money is enhanced by this demand. The value of gold increased when it came into demand for monetary purposes. Similarly, the value of silver rose when it was demanded as money. When money conditions changed in the course of the nineteenth century and silver became less important for use as money, its value per unit, its purchasing power, tended to go down.

Inflation is an increase in the quantity of money without a corresponding increase in the demand for money, i.e., for cash holdings. I do not

mean to say that inflation in itself does not influence the demand for money. The quantity of money and the demand for money are not absolutely independent magnitudes. The demand for money for cash holdings depends on the individual's specific understanding of future conditions—his speculation and his ideas about the future.

At the start of an inflation, that is, at the beginning of an increase in the quantity of money without a corresponding increase in the demand for money, it causes a rise in prices. Then, if the people have learned something from theory or from history, they may anticipate still further price increases. In that case, they expect prices to rise and the purchasing power of each money piece to decline and they will tend to restrict their cash holdings, as compared with what they would have in the absence of such speculation as to the future purchasing power of money. This depends on the speculative reaction of the public. On the other hand, if people think prices will drop, there will be a tendency for them to increase their cash holdings in the expectation that the purchasing power of money will rise.

By and large, an inflationary change in the purchasing power of money is caused by the fact that a few people are quick enough to realize what is going on and to adjust their activities to the inflationary policy of the government. They do not always have great minds. Nor are they necessarily more intelligent than others. They just react more quickly than others. In Germany and Austria when there was inflation after the first World War, some "silly speculators" were pushed by accident into buying stocks on margin. It was not that they were clever, but the bankers were less clever. The banks held the common stocks, financed the sales, and sold the stocks to some speculators on margin. In a very short time, the speculators became extremely rich. And then very soon they lost what they had gained because they didn't know what was going on.

Not everyone distrusts their government in this respect, as these quick ones must have. So long as those who are quick in anticipating inflation are in the minority and the slower ones are in the majority, so long as the housewife postpones purchases in the belief that prices will drop, telling herself that everybody, the government especially, says prices will go down, the inflation can continue. This mentality is the basis for inflation, the rock on which it is built. As more and more people discover there is something "fishy" about the government's statements and then when one day everybody discovers it, the whole thing begins to break down. This change comes overnight. It comes when the housewife decides it is better to buy

immediately rather than to wait until tomorrow, or until next year, because then prices will be still higher. In Germany after the first World War this was called *Flucht in die Sachwerte*—flight into true values.

This is a characteristic of every inflation that is not stopped in time. The first period may last many years; the government is then triumphant. The second period lasts for only a very short time. In Germany the first period lasted from August 1, 1914, until the end of September 1923; the second period lasted only three or four weeks. The second period in Germany was characterized by the fact that the workers were paid every morning in advance. Their wives would go with them to work; each man received his money, handed it immediately to the Mrs., and then she went to the nearest shop to buy something—anything—just to get rid of the money. To buy something was better than to keep the money which would lose value by tomorrow.

Such inflationary adventures have happened several times in the course of history. Most have been stopped by the governments before the second period. The three most important times when inflation has run its course are (1) the United States with the Continental currency in 1781, (2) France in 1796, and (3) Germany in 1923. There have been inflations in other smaller countries too, such as Hungary, but they were not so important.

The situation of the southern states with their Confederate currency in 1865, was another matter. It could be said it was different because the Confederate government itself broke down with the defeat of its forces.

In the twentieth century, Karl Helfferich [1872–1924], an excellent writer and a gifted economist but who lacked the qualities that make a man stand up for his opinions in public, invented a slogan: the money of the victorious nation will prove to be the best and will retain its value after a war. But this has not been the case in history. In the United States in 1781, the colonies were victorious; they had just defeated a great country, Great Britain, and yet the Continental currency degenerated. Also in 1796, France had been successful in military campaigns, and yet she suffered inflation. Helfferich was doubly wrong when it came to Germany—first, in thinking Germany would be victorious in World War I, and secondly, in believing that its money, as the money of a victorious nation, would necessarily be good. Helfferich failed to realize that whether a country is rich or poor doesn't matter—when it comes to inflation what is important is its basis for putting additional money into circulation.

Every inflation that isn't stopped in time consists of two periods—the catastrophic crack-up boom, which is very unwelcome, and the runaway

inflation. It is an economic law that things happen in this way. The length of the first period depends on conditions which we may call psychological; it depends on the minds of the people, on their judgment, on their trust in their government. And it depends on their ideas, on the pseudo-economics with which they have been indoctrinated. So it is impossible to estimate how long the first period will last.

The Germans were definitely indoctrinated. They had confidence in their government. Even as late as October 19, 1918, they believed they would be victorious in the war and they thought their money was safe. They blamed the speculators for raising the cost of the U.S. dollar. The unsophisticated eighteenth-century farmers in the United States and in France had better judgment in these matters than did the sophisticated bankers in Germany. Let us not forget that the German banks broke down in this period because they were ignorant of the problems involved in the inflation.

This leads us to an explanation of why price controls cannot work. The government increases the amount of money. This is the inflation. Everybody has more cash in their cash holdings than before. The result is that the individual has a surplus of money which he hasn't spent for daily consumption. In his eyes this is a surplus cash holding. If he doesn't prefer to buy some luxury goods, he wants to invest a part. The small man invests it in savings banks or insurance policies. The big business enterprise appears with this amount directly or indirectly on the loan market. For a while the government succeeds in keeping prices down. Price control doesn't remove the danger. But by making it easier for people to buy at low prices what they would have bought anyway, it increases the amount of money in their pockets, in their cash holdings, which is available for other purchases.

The inflations of the two World Wars in this country were comparatively mild because a great part of those workers who had earned additional money tended to increase their cash holdings during the war. The small worker really did increase his cash holdings in anticipation of a post-war move and because some goods were not obtainable during the war—radios, refrigerators, automobiles, and so forth. This is a characteristic of the first period of inflation. Remember the housewife who says, "let us keep the money; next year prices will be lower." But as soon as people discover that things may be otherwise, the catastrophe may occur. These explanations of the simple man make the situation critical and dangerous.

Today [1951] there is still powerful resistance to inflation. There is still

a lot of talk about the necessity of restricting inflation. It is true that 90 percent of this talk is just nonsense consisting, for instance, of plans to conceal the inevitable effects of the inflation by price control. But nevertheless, as long as there is such a resistance and as long as the government and Congress are forced to concede that there is danger in inflation, the danger is not yet great. The breakdown occurs when government officials no longer care what happens and fear that they may not be in control later.

During the last World War in most of the countries the economists were prevented from saying what was happening in their own country because of censorship. Or they were prevented from talking because they were in the army. But in the first World War, not all the countries were involved. In Sweden, which was neutral, there was an economist, Professor Gustav Cassel [1866–1945]. As a neutral, he had the privilege of visiting Germany one week, England the next, and in between of stopping in the Netherlands and Belgium. He wrote about what he saw. Cassel told the Germans, "You are inflating your currency and your profits are not real profits but illusionary profits." He told them they must take the additional money out of the system (1) by taxes and (2) by loans. But the Germans did not have the courage to tax those who had received the extra part of the money. They tried an excess profit tax, which removed only a small part. They tried loans in this way—in order to buy 100 Marks of such a loan, the citizen had to pay only 17 Marks and the remaining 83 Marks to pay for the loan were provided by the government's printing new banknotes. Thus, every new issue of bonds meant an increase in the amount of money. This shows how even the best advice is useless in the hands of people who have such ideas.

Now I want to deal with the second problem. In the second part of the eighteenth century, Great Britain was on the gold standard. This was evident to everybody because there were gold coins in use every day in daily business transactions. Also in use were notes of the Bank of England and, at that time already, the beginning of checkbook money. The banknotes were used as money substitutes and were redeemable immediately, without any delay or excuse. This was the gold standard as it existed in England in the eighteenth century, and as it was adopted in the course of the nineteenth century by the more important continental countries of Europe—France, Germany, the Netherlands, Belgium, and the Scandinavian countries.

Adam Smith had suggested that if all travel could be done by air, the land then used for roads could be put to more productive use such as farming. In this same vein, economists began to ask whether or not it was really necessary that mankind devote a part of its toil and trouble to the production of precious metals in order to have a good currency. If one could construct a currency with less expense, it would be advantageous. In 1819, Ricardo reasoned that one could do away with gold coins and have only banknotes which should be redeemable, not in coins, but in ingots, bullion. This gold bullion could be used for international transactions. This would save the money involved in making gold coins in smaller denominations. For more than 60 years Ricardo's suggestion remained a "dead letter."

In the 1870s, countries, that were having a hard time financially and yet wanted to get on the gold standard in the cheapest way, discovered this solution of Ricardo's. It was called the "gold-exchange standard." Toward the end of the nineteenth century and the beginning of the twentieth, many countries adopted this type of gold-exchange standard. It differed only in degree from the classical gold standard. On behalf of the American public, Professor Jeremiah Jenks [1856–1929] of New York University studied this gold-exchange standard in the Far East—the Malayas, the British West Indies, and so on. He was enthusiastic, as was his assistant, Professor Edwin Walter Kemmerer [1875–1945]. People didn't see anything questionable in this theory. I can't say that I was enthusiastic myself, but I couldn't see any reason why it shouldn't be adopted. One German economist said that by concentrating all the gold in the hands of the government, it would make things easier in time of war. What it does is to make it easy for the government to manipulate the currency, which always means to manipulate it downward, thus preparing the way for inflation. When a country has a gold-exchange standard and no gold in daily circulation, no one realizes what it means when the government declares that banknotes are no longer redeemable.

When the first World War broke out all the countries went on the gold-exchange standard. There was still a little gold in circulation, but not very much. Even the countries on the gold standard had gradually approached the gold-exchange standard more and more. Soon in place of the gold-exchange standard fiat money standards came in all countries. After the war, all countries were eager to return as quickly as possible to the gold standard. But most only returned to the gold-exchange standard

by making the domestic currency redeemable in foreign exchange, and giving that to the people instead of gold. But in 1929, with the crisis, people began to advocate something else.

The gold-exchange standard with a flexible parity was known as the flexible standard. When the banks had issued banknotes they really redeemed the money; a discrepancy of one-tenth in the parity at which the notes were redeemed was considered disgraceful. (Incidentally, in the 1870s, French banking was centered in Paris and the gold was in Paris, which was in the hands of the Communists. Yet even then a deviation from parity of 5 percent in the currency was considered terrible. Today [1951] a currency is considered stable if it deviates no more than 20 percent.) The redemption of their notes by the central banks was controlled by the public, because the central banks were obliged to publish a statement every week telling the public the whole situation.

Step by step, governments acquired the opportunity to replace the gold-exchange standard with the flexible standard, which meant parity was no longer determined by law but perhaps by a bureaucrat. Bank transactions were transferred from the bank to a new agency. In Britain, this was the Exchange Equalization Account. First of all, parity was no longer fixed in the same way as before; it was surrounded by secrecy. From time to time the newspapers printed a statement that the currency was weaker, which meant that the bureaucrats had changed the parity a little bit. From time to time it was changed to a greater extent depending on the country and so forth. Devaluation could occur even in a country ostensibly governed by democratic methods. In Switzerland in 1936, even though assurances had been given that the Swiss franc would not be devalued, it was accomplished in half an hour by a meeting of Parliament. They really had no choice—the preceding policies, such as subsidies to agriculture, the watch industry, the hotels, and so on—had put them on the spot. And even in such a democracy, the change was accomplished by administrative action.

The flexible standard was defended by Keynes and his followers as a great thing, but it disappeared when something even "greater" was substituted. Great Britain's return to the gold standard at US$4.86 in April 1925, had led to higher import prices, declining exports and unemployment. In 1931 [September 21], Britain abandoned the gold standard and the value of the pound sterling was left to fluctuate. It declined.

Money is like any other commodity. As there is no custom line between Manhattan and Brooklyn, prices increase between the two

boroughs only by the amount of transportation charges. If there were a custom barrier, conditions would be different. So it is with money. If Brooklyn had a separate coin system from Manhattan, the exchange ratio between these two moneys would be established at such a height that it would make no difference whether the commodity was bought in one place or the other, with one money or the other. Should a difference appear, immediately there would arise an opportunity to make an advantageous deal. This advantage would continue until the difference disappeared.

We speak in the same way of Great Britain's devaluation in 1931 when it went off gold, and her devaluation of two years ago [September 18, 1949] when the rate was changed from $4.03 to $2.80. But these are two absolutely different things—they have nothing in common. In 1931, when the British abandoned the gold standard, the amount of foreign money or gold that the owner of a British banknote had been able to obtain was reduced. It was intended by this means to keep the British currency stable with reference to foreign currency. The British government assumed a monopoly in the trade of gold and foreign exchange and the right also to expropriate foreign exchange. In revaluing, what they had had in mind was changing the rate at which British holders of foreign money would be indemnified on the one hand, and on the other hand the rate at which the importer would get his foreign exchange from the British government.

Two years ago in Great Britain, the $4.03 parity was a historical fact like any other historical fact. It was a parity *de facto*—it was the legal norm for the expropriation of Britishers who owed foreign money, and the price they had to pay for foreign money. But in fact the pound on the world market was worth only $3.00, more or less. In a treaty with the United States the British government promised that on a certain date they would again begin to redeem their currency against gold, dollars, and so on. But the British government no longer had clever bank-economist advisers. They had not considered what it would mean if it should be possible to redeem the money in London in the relation of three to four; anybody in the world would be able to buy a pound for $3.00 outside the United Kingdom and then sell the same pound to Great Britain at $4.00. After four or six weeks they discovered that this was completely unrealistic.

7TH LECTURE

The Gold Standard: Its Importance and Restoration

THE QUESTION WHICH I WANT TO TREAT TONIGHT presents an excellent opportunity to illustrate one of the points made in the epistemological lectures—to explain the difference between economic ideas and judgments of values. As an individual I have a very definite idea of the political problem involved. The important point is that everybody who wants to arrive at such a judgment of value should know why he is doing this and he should understand the consequences of his action.

The question is how to return to the gold standard. And at what parity the return of the United States to a gold standard should be effected. We assume that we *should* return to a gold standard. A fiat money system cannot go on forever and must one day come to an end. The gold standard under present conditions is the only standard which makes the determination of the purchasing power of money independent of the changing ideas of political parties, governments, and pressure groups. The question is how should this return be effected—by accepting a gold price of $35 an ounce? Or by determining the price of the ounce of gold according to the market conditions at the time of the transition?

First of all, we must know why such problems are important. They are important because changes in the purchasing power of the monetary unit must necessarily bring about social consequences with respect to the income and wealth of various members of society. If the changes brought about by a shift in the money relation, that is by an increase or decrease in the quantity of money in relation to goods and services, would affect the

various commodities and services to the same extent and at the same time, then the only consequences would be its repercussions on the content of old contracts concerning deferred payments, loans, and so on.

Let us deal with the social consequences due to the unevenness and lack of synchronization in the change of purchasing power brought about by inflation or deflation. Should these changes occur everywhere at the same time and to the same extent, people would discover one morning that the purchasing power of the monetary unit had changed overnight. But otherwise there would be no difference; the prices of the services they had been selling would also have changed by the same amount and in the same direction.

In inflation, the additional quantity of money enters the economic system through the wealth or income of definite individuals. If the government prints the money, the government is the first to get the new money. Additional demands and offers raise the prices for the products the government wants to acquire. The persons selling the commodities and services the government wants sell at higher prices. Then munitions workers, munitions entrepreneurs, and the soldiers all receive more than they did yesterday. These persons, in whose cash holdings this additional money appears, are in the position of being able to offer more money for their purchases. They have more money and larger incomes. Consequently they can spend more and they offer higher prices for the commodities they purchase. But these people don't buy everything. Perhaps they buy beverages but not books.

There is now a second group favored by the increase in the amount of money, let us say the beverage producers who are getting more for the services and commodities they sell. The members of this second group are now in a favorable position because the services and commodities that they wish to purchase have not yet been affected. But other individuals—teachers and ministers, for instance—are still paid the former rate; in spite of the fact that the additional money has not affected the services they are selling, they must pay more for commodities that others have bid up in price.

In such an inflationary period there are losers and winners. The winners are the munitions workers, those selling products which go up in price at an earlier date than the commodities they are buying. As long as this continues there are problems every day. The winners are satisfied and keep silent; they don't write letters to the editor to say that this is a wonderful thing. The entertainers, beverage salesmen, and others do good

business at the time—they are the winners—they don't talk, but they enjoy prosperity and spend. The losers are the other way round. Those at a disadvantage feel it. The housewife whose husband is still earning the same salary and has a number of children to feed is at a disadvantage. Until the inflation ends and for a long time afterwards there are losers and winners because such maladjustments exist. One hears in public only the voices of the losers.

In deflation, the same thing happens, but the other way round. There is a decrease in the amount of money. Those whose selling prices drop first of all are the losers; the winners are those whose selling prices drop at the end.

These price changes are the most spectacular effects of inflationary and deflationary changes in the amount of money.

Another characteristic of inflation is that all deferred payments are changed in their importance. If on the eve of the inflation you had borrowed $100 which could at that time buy ten A's and if after six months as the result of the inflation, $100 can buy only five A's, what you pay back to the creditor is worth less than before. You could, therefore, borrow money, buy ten units of A, wait six months and sell five units of A for $100 to pay back your loan; your net inflation profit would be five units of A worth $100; you, as the debtor, profit. The man who saved, the creditor, is hurt by the inflation. In order to deal with today's problems, these things must be kept in mind.

Before the war of Great Britain against Napoleon from the beginning of the nineteenth century to 1815, there had existed in England the classical gold standard—there were gold coins, and there were banknotes of the Bank of England in use as money substitutes. The Bank of England notes were redeemable in gold on demand; the paper was a gold substitute. Because people could get gold without delay, Englishmen took the notes without any hesitancy. This gave the government the idea of borrowing from the Bank of England and the British government found that was the easiest way to get money. As a consequence of their borrowing the quantity of domestic money increased and prices rose. With the rise of prices in Great Britain and not in foreign countries, merchants found it advantageous to import. In order to pay for these imports it was necessary to export gold. So more people asked for redemption of the banknotes. The managers of the Bank of England became alarmed and feared bankruptcy. The government suggested a very easy remedy; they passed a law relieving

the Bank of England of the obligation of redeeming their banknotes; they suspended the payment of specie. The law made meaningless the statement on the banknotes that they could be redeemed.

The government borrowed more and more. A higher price for gold resulted. Gold coins were handled at an additional premium. The official rate before the Napoleonic Wars was one ounce of gold to £3 17s 10½d. In 1814, shortly before the end of the war, the actual price in terms of the Bank of England notes was £5 4s. The gold price had risen almost 50 percent in terms of British pounds; in other words, the value of the British pound had declined.

After the war of Great Britain against France ended, Great Britain decided to return to the gold standard. The only method considered was to deflate and return to the pre-war parity—£3 17s 10½d per ounce of gold. So they reduced the amount of money; they contracted. To deflate the government must borrow from the public—not from the banks. And it must not spend the money which comes in; it must destroy it. This is difficult as you can imagine. You will rarely find Ministers of Finance who are ready to do this. But at that time it occurred—because they believed it was the only "honest" and "just" way.

Now, let us see how "just" and "fair" such a method is. If a man had contracted a loan before 1797, and had not yet paid it back, it would have been correct to say he should pay the pre-war value. But don't forget that many people had borrowed money during the period of the suspension of specie payment on the part of the Bank of England. Many British farmers especially, who wanted to improve their property to assist England to survive the war when imports were not easy, had mortgaged their farms and received the devalued or "light" pounds. And now came a law which required them to pay back "heavy" pounds. Is this "fair"? Is this "just"?

For these farmers there was still another complication. When peace returned, imports increased and they had to compete against more imports than before the war. While their debts and their payments of interest and principal increased, the price of their products dropped. These two factors contributed to a tremendous agricultural crisis in Great Britain in the 1820s. Among the important consequences of this crisis was an intensification of the Corn Laws, which were later abolished in the 1840s.

The government was also a borrower and had borrowed "light" pounds. Yet according to the new law the government—which was the taxpayers—had to pay back "heavy" pounds. Thus a privilege was granted

those persons who had bought government bonds with "light" pounds and who were repaid in "heavy" pounds.

There also resulted all the consequences of price changes. There were winners and losers. This brought about a very great powerful drive for inflation in Great Britain, led by the so-called group of "Birmingham Little Shilling Men." After some years, when all the changes had been effected, the crisis disappeared. Part of the nation had been enriched at the expense of others who were impoverished. Finally Great Britain enjoyed stable money again.

During the first World War, the British government again embarked on an inflation. The pound was devalued against its gold equivalent. Then after the war the government wanted to return to the gold standard. But again they didn't realize that to return to the gold standard at the pre-war parity of the pound would bring a sequence of events similar to that which occurred after the Napoleonic Wars. It was inexcusable that the great British Empire did not know how to go about it. They didn't understand the theory, nor did they know the history. They had had the experience but didn't recognize it. The situation was once aptly described by a Swedish man [Count Oxenstierna] who said, "Dost thou not know, my son, with how little wisdom the world is ruled."

In 1922, Lord Keynes had already written a book in which he pointed out that domestic stability is more important than the stability of foreign exchange rates. I remember when I had a talk several years before this occurred with a British banker, not a socialist agitator, who told me, "Never again will the British people have to pay a higher rate of interest to the usurers of the world market for gold in order to keep a British currency at parity." These were the ideas that prevailed, you know. And it was the same in this country.

When Britain returned to the gold standard after World War I, the Chancellor of the Exchequer at the time [1925], Mr. Winston Churchill, returned to the pre-war parity of the pound. He didn't know that conditions were different in Great Britain than in other countries. London was the banking center of the world before the first World War, and for this reason foreign nations kept considerable amounts of deposits with the British banks. When war comes, these foreign deposits are called "hot money," because depositors fear inflation and devaluation of the pound. They are anxious to withdraw their money but will wait if they believe that Great Britain will return to the pre-war parity.

The British didn't know what they were doing in 1925 in returning

to the gold standard. Even the most stupid man in England should have known that the British labor unions were adamant in their demands for higher wages and that wages had been raised to such a point that there was permanent unemployment, with millions of persons out of work. Yet, in the face of such a situation, the British government increased the value of the pound. They made the "light" pound the "heavy" pound, thus increasing the real wages of workers without any change in the number of jobs. The result was that British production costs, which were already high under the existing wage rates, too high for the world market, were enhanced even more.

Great Britain made a bad mistake by returning to the pre-war parity of the pound in 1925. This added to the income of persons who had bought bonds or otherwise lent money in "light" pounds. The government had to collect more taxes to repay those bonds in "heavy" pounds. A catastrophe resulted. The United Kingdom cannot feed and clothe its population out of domestic resources; it must import food and raw materials and pay for these with manufactured goods, most of them produced from imported raw materials. They found themselves in a situation where they were unable to export enough to preserve their standard of living. Labor unions would not consider a reduction in wages.

To avoid hurting the interests of those who lent "heavy" pounds, it would not have been necessary to return to the pre-war parity. It could have been arranged that a loan contracted in 1910 would be paid back in a higher number of pounds than when contracted. Although this might have helped, it wouldn't necessarily have been "just" or "fair," because the bond might have changed hands several times.

Because of the problems that developed, the government capitulated in 1931, by devaluing the pound four times more than it had been devalued before 1925. This meant that Great Britain, still a great creditor nation, made a gift of hundreds of pounds to foreign debtors who, after 1931, could pay their debts to Britain in "light" pounds. What kind of statesmen were these? Winston Churchill, as Chancellor of the Exchequer, was badly advised.

Now in the United States, we have the question of how to return to the gold standard. In my opinion, there can be no question as to the necessity for doing that. But the question is at what parity we should return. Should it be determined through stabilization, by abolition of the laws against holding gold, and stopping the increase in the quantity of money? Within a short time after some haggling, there would be more or

less a price for gold which would not affect the purchasing power. One could then return to the gold standard. Leaving aside the problem of old debts, this wouldn't change anything—this wouldn't destroy the whole economic system.

But there are among the minority favoring a return to the gold standard very eminent men who favor resumption of specie payment at the rate of $35 an ounce. They say this is the only "honest" solution. I don't know why these gentlemen are precisely in favor of $35. One must stabilize at the present-day gold value of the money without deflation. To return to the gold standard at $35 per ounce of gold would cause a deflation, because today [1951] $35 is no longer considered the equivalent of an ounce of gold. The price of gold is much higher, as can be seen from the quotation of the American dollar in Switzerland and other neutral countries. If the American government redeems the dollar at $35 there would be a tremendous withdrawal of gold from this country, which would make the whole thing unpopular.

If one wants to deflate after considering all of the tremendous disadvantages of deflation, if one wants to go back to an old value which has only a theoretical value, why go back to the New Deal value, which was never anything but a specter in the law books and never had any real significance to Americans? Why not go back to the original old United States dollar—$20.67? Why just the New Deal dollar? They say it is a statutory dollar. Of course, $35 is the rate for foreigners, not for Americans—it is a criminal offense for Americans to own gold—at which governmental international dealings are made. [The prohibition against owning gold in this country has since been repealed. In January 1975, U.S. citizens regained the freedom to buy and own gold.] Many gold producers have been forced to sell gold. But US$35 is not the real market parity for gold. I don't see why anyone should want to take on the disaster of a deflationary movement. Deflation is so very unpopular. Its unpopularity is exaggerated, but it couldn't work because people are so opposed to it.

I see only one way to return to the gold standard—abolish laws against holding gold, re-establish the gold market and see what rate establishes itself. This would cause the least possible disruption. The greater part of gold is outside of this country. The U. S. government could keep quiet for a time, and not enter the gold market. There would be a drop in the price of gold on the black market. Nobody can know in advance how much the

free gold price would be—but I would guess somewhere between $38 and $40. Then we could have a gold standard.

As a citizen I have my opinion. I don't say it is wrong or dishonest to advocate a return to gold at $35 per ounce, but I say you are living in an illusory world if you believe it is possible to present the American people with a deflationary program such as returning to the $35 rate would mean. $35 is nothing but the rate of Mr. Morgenthau [Secretary of the Treasury under FDR's New Deal]. Why take the New Deal dollar? If I know these advocates, they are not very enthusiastic New Dealers. The $35 an ounce gold ratio started in 1934, but eighteen years have elapsed since then.

Some people believe you cure inflation by causing deflation. This is a little like suggesting that to cure a man who has been run over by an automobile going from north to south, you should run the car back over him again from south to north.

I agree it will be difficult to return to the gold standard. But the first step is to re-establish the gold market. Eventually there will be a gold price. At first the government could say it wouldn't sell more gold at this price than it had sold on the average, for instance, over the last ten years.

The United States went off the gold standard because it was believed that inflation was beneficial. We wanted to adjust the standard according to prices. We imitated Great Britain, which went off the old parity in 1931. There was the depression and unemployment in the United States, and consequently it was necessary to adjust wages downward. This was not done. The devaluations of 1931 in Great Britain, of 1934 in the United States, and of 1935 in the Latin Monetary Union took place because the governments and the people were too weak to resist the labor unions. The labor unions believed that the higher the wages are, the better it is for labor. But if wages are raised above the market rate the result is permanent unemployment. Don't believe that I am in favor of low wage rates. However, low wage rates were the necessary, inevitable consequence of the fact that there were more and more trade barriers in the world and more and more capital consumption. Tariffs reduce production all over the world and wage rates must go down. Prices are adjusted according to the standard. Trade barriers shift. Production goes from those places in which a smaller input produces a greater output to places where it is the other way around.

Let us say this, for instance: If the Portuguese government raises the tariff for something that the British used to export to Portugal, and conse-

quently there develops in Portugal an industry of this type for which conditions in Portugal are very unfavorable and where, therefore, the costs of production are higher, and the British are forced to restrict their exports and must develop other industries for which the conditions in Great Britain are very unfavorable, the result is a general drop in productivity all over the world. Along with this there is the necessity to consume less, which means, for the worker, lower wage rates. And you cannot change lower wage rates by picketing. Pickets don't keep wages up.

Therefore, if you say it was for the first time that a country walked off the gold standard when there was no reason to do it in world history, I would say it was not precisely for the first time.

The quantity of gold reserves doesn't matter. If there is not a special reason to reduce the reserves, you must effect this transition to a gold standard at a rate at which current transactions do not change the amount of gold. The main thing is to find the parity at which the market can maintain without the transfer of gold.

The black market is a market. There is nothing "black" about it. A black market price takes into consideration the risk. When the blackness is taken away from this market, then prices will probably drop. So will it be with gold.

I don't believe the danger of a runaway inflation is imminent because there are enough powerful people who are opposed to it to prevent it.

I am in favor of gold coins so that the individual will be involved, so one will realize when the slightest inflation takes place. The fact that the individual citizen can see when the situation changes is one of the most important checks of the Constitution against inflation.

The world is on a gold standard, but the United States is on a paper standard. A return to the gold standard is possible economically, but not politically. The present government is built on such tremendous domestic expenditures that if the people are not actively opposed, the government will always inflate. The advantage of the gold standard is that the purchasing power depends on conditions which are not subject to governments, political parties, and changing codes, creeds, and desires.

There is nothing divine about the gold standard but there are some reasons for it. The gold standard is a human institution. It has come into use through the course of history. The gold standard prevents the government from increasing the amount of money through inflation.

It is impossible to keep a fiat money stable. A very able economist, who

was sometimes rather fantastic, the late Irving Fisher [1867–1947], was convinced that you could measure the purchasing power of money. He talked about the housewife's basket filled with $10 worth of purchases. He believed that the purpose of keeping the purchasing power stable was to make the monetary unit such that it always buys the same assortment of various commodities. This is wonderful if you pick out as the standard lady of the world, a certain lady at a certain time. But for only a short time, for each person's purchases are different, and each person's purchases vary from time to time during a lifetime. How much gasoline did grandmother buy? How about baby food when the children are in college?

Irving Fisher neglected the unevenness and dealt only with markets as a standard of deferred payments. He started his movement in the field of monetary stability at a time when the drop in purchasing power was not very great. He started it because he was in favor of the creditors, which is remarkable in itself because very few people are in favor of creditors. Generally people are in favor of a steady slow downward movement of the purchasing power which favors debtors.

Sound money is that money the changes in purchasing power of which are very slow so that they do not affect business seriously.

Gladstone said, not even love had made so many people crazy as money.

8TH LECTURE

Money, Credit, and the Business Cycle

THE BEGINNING OF MONEY SUBSTITUTES is very well known. People in Great Britain used to keep deposits of gold with the goldsmiths in London. Later they began to use the receipts from the goldsmiths as substitutes for money in transactions and cash holdings. The difference between a ticket entitling a person to a definite amount of money and a ticket entitling him to a certain amount of bread is that if he wants to get the bread he must cash the bread ticket, although he may use the money ticket itself to get the bread provided the baker considers the money ticket of value and wants to use it as cash holding.

Goldsmiths soon discovered that they could issue more money tickets, more money substitutes, than they had gold in reserve. This meant an addition to the nation's quantity of money in the form of fiduciary media and money certificates, over and above the quantity of gold in reserves. A problem arises because fiduciary media may be created out of nothing; theoretically there is no limit—or so it appears.

The creation of fiduciary media represents a factor that brings about a rise in prices. If the fiduciary media appear on the loan market, as an additional supply of loan money, there is another effect also; the increased supply causes, immediately and temporarily, a reduction in the rate of interest. There cannot be any argument that the rate of interest is a real market phenomenon that arises out of the time preferences of individuals; it is not solely a monetary phenomenon. However, the rate of interest is affected by an increase in the amount of money appearing on the

loan market. An increase in the amount of money appearing on the loan market brings about a drop in the monetary rate of interest. How does this readjustment take place? This is the problem of the trade cycle.

In dealing with money substitutes and fiduciary media, i.e., that amount of money substitutes in excess over the reserves of the bank, we must never forget that the position of the banker or of the bank issuing such fiduciary media is delicate. Only if the banker has the good will of the people can it be assumed that they will be willing to hold these excess money substitutes and not present them for redemption, which would push the bank into bankruptcy. It is even more important to realize in the first place that it is not very easy to make the people accept money substitutes as money. Originally money substitutes were looked on with suspicion; people were not very enthusiastic about accepting them in place of gold. It is difficult for our contemporaries to realize this, because money substitutes protected by the government have appeared in recent years and been forced on the people by the government. Moreover, today these money substitutes have been declared to be legal tender, so that if a debtor wants to repay a debt, the creditor is bound by law to accept the money substitutes as if they were real money.

Propagandists who wanted to make the government pre-eminent in the issuance of money substitutes have publicized many stories about private money substitutes. These tales were condensed by an anonymous American who is credited with the dictum "Free trade in banking is free trade in swindling." Economists, however, think differently; they consider free trade in banking as the only protection against the government's issuance of bad banknotes.

The main problem is that unfortunately all people, even in the age of liberalism and classical economists, consider the rate of interest as a monetary, not a market, phenomenon. The classical economists explained that prices and wages were market phenomena, but they were not so anxious to say that the rate of interest was also a market phenomenon. This is one of the weaknesses of Adam Smith's *The Wealth of Nations*. He refuted the idea that a scarcity of money can make business bad. But he was not prepared to attack the age-old laws against high interest rates, the laws against "usury." Jeremy Bentham, in his *Defense of Usury* [1787], which is still in use today, was the first to refute these old ideas of interest.

People considered high interest rates a barrier to economic trade and progress, and felt that anything that might lower the rate of interest a

blessing. Consequently an increase in money substitutes was considered a blessing because with it came a lowering of the rate of interest. All other things remaining equal, if an additional offer of loans by the person making the money, by the bank of issue, is made, the would-be lender must drop the rate of interest to attract additional borrowers. This was considered advantageous and there was enthusiasm for it on the part of public opinion.

It is tragic and fateful that not all liberals realized that the rate of interest was an economic, not a monetary, phenomenon. These liberals not only failed to fight, but they even aided the foundation of additional government central banks with special privileges because they thought these banks would lower the rate of interest. The consequence was a lowering of the interest rate in the short run, a short-run boom—but later, inevitably, after some time, the appearance of an economic crisis, a depression. People began to consider periodical depressions and the trade cycle as inherent characteristics of capitalism. This has been one of the main arguments for socialism and one of the main causes of making people anti-capitalistic. The effect of the 1929 depression in this county is still evident in the erroneous interpretation of this experience by the people.

As a consequence of the belief in the advantages of low interest rates, credit expansion became very popular—at first in those countries where there was capitalism and a banking system. At the end of the eighteenth century, Great Britain was already suffering from the consequences of recurring economic crises. Later these crises began to affect other countries—at first the European countries that were more advanced in capitalism—the Netherlands, France, and the most advanced city-states of Germany, Hamburg, and Bremen. These periodical crises came to other countries only with the spread of capitalism. For instance, in the depression of 1857, Austria was still rather backward in the capitalistic development so that she was affected only very slightly. The Austrian government did something which was very spectacular for those days. For political reasons, Austria wanted to aid Hamburg. She shipped a full trainload of silver under heavy soldier guard to Hamburg to support Hamburg's banking system. At that time, Austria was still out of the world. But in 1873, when the next depression came, Austria was so much involved that Vienna was the center of the crisis.

Economists began to raise the question as to what caused these crises. Say's Law demonstrated only what could *not* be considered the cause—overproduction. A little later a group of English economists and bankers

began to realize that the problem was the boom-bust trade cycle and that the cause of the bust, the depression, was the preceding boom. To eliminate the depression the preceding boom and credit expansion by the banks must be eliminated.

But this was not a complete explanation. It was an explanation of conditions in Great Britain and the few countries already equipped at that time with such a banking system. This was an explanation under the assumption that the rest of the world did not have such a credit expansion. For example, the Currency School argued that if there is credit expansion in England, which results in a boom and higher prices in Great Britain while conditions hold prices in other parts of the world stable, exports diminish and the balance of payment becomes such that gold bullion is shipped out of England to other parts of the world. The holders of the banknotes seek to redeem their notes. The reserve of the British banks drops so that the banks must restrict their issue of notes in order to protect their own solvency. This brings about the depression. This is correct as far as it goes, but it does not take into account the fact that all countries might expand their currency, so that then there would be no explanation for an outflow of money.

The Currency School's theory made one great mistake—it failed to realize that it made no difference whether inflation was caused by banknotes or by checkbook money. Legislation in 1844, Peel's Act, made it impossible to expand money by means of banknotes in England and other countries adopting similar legislation. But the legislation limiting banknotes said nothing about checkbook money. Consequently, this law of 1844 didn't stop booms. Another boom, based on checkbook money, appeared already the next year, leading people to feel the whole theory was worthless.

This Currency School's theory was the basis of the Banking School's quantity theory of money. The British Banking School developed the theory that there is a certain demand by business for money. If the bank restricts its creation of bank money, checkbook money, and banknotes, to the "needs of business," they say it can never bring about an inflation. Let us assume that the bank of issue discounts only bills of exchange which are the result of an actual business transaction. The cotton merchant sells a quantity of cotton to a cotton spinner, and the spinner needs money to pay for it. He draws the bill, which is discounted by the bank, which creates additional money. After three months when the raw cotton has been converted into cotton yarn and is sold, the loan is paid back and the money

disappears. Under this system it was believed that the "needs of business" automatically produce the amount of money business needs.

This theory was as popular in the second part of the nineteenth century as it was false. The idea that the "needs of business" would automatically limit the creation of additional money is mistaken. When it has been applied in practice it has resulted periodically in inflationary booms. No one minded the booms. But the booms were succeeded by depressions which the people didn't like.

For 50 years there was no progress at all in this study. Then, at the end of the nineteenth century there was published a book by the Swedish economist Knut Wicksell [1851–1926], *Geldzins und Güterpreise* [1898, English translation, *Interest and Prices*, 1936]. Wicksell pointed out that the amount of such business transactions is not independent of the behavior of the bank. If the banker reduces its rate of discount, the amount the purchaser must pay for his raw material is less, and the transaction seems more profitable than it would otherwise. Thus, banks may increase the "needs of business" by lowering the interest rate. And when the interest rate is lower, the banks expand, which is inflationary. Thus, the demolition of this theory was due to Wicksell. And then in 1912, my book, *The Theory of Money and Credit*, came out. The foundation of this theory can be traced to the originators of the theory of interest—W. Stanley Jevons and Böhm-Bawerk. This is the monetary theory, the circulation theory, or the Austrian theory, of the trade cycle.

Peel's Act was in 1844. The next boom was in 1845 and 1846. The depression followed in 1847. In 1848 came the *Communist Manifesto*, which said that the capitalistic system leads to periodical crises. Each crisis, the *Manifesto* said, would be progressively worse until it would lead eventually to the breakdown of the capitalistic system. In 1857, 1866, 1873, and again in 1929, the Marxists were awaiting the day, *"der Tag."* And today in Moscow, Stalin waits for the final crisis of the capitalistic system in the belief that it is just around the corner. What is worse is that so many economists think this way too. This is the philosophy of the League of Nations and of the many "disunited" peoples in the United Nations. They do not believe that the occurrence of depressions has anything to do with credit expansion; they believe that trade cycles are inherent in the capitalistic system, and that a special committee must be formed to fight the trade cycle.

At the beginning, the popularity of credit expansion was due to the idea that it is a blessing for every country and for the whole world to have

a low interest rate. Credit expansion was considered a vehicle to lower the rate of interest. The politician wanted prosperity for his country, and for the people. Governments wanted to keep interest rates low; even Coolidge in 1924 wanted low interest rates. It seems to me astonishing that attempts have been made to raise and lower wages, to raise and lower prices, but you will never find an occasion when a government or politician was in favor of raising interest rates. I don't mean to say I am in favor of a high interest rate—I am for the market rate.

When governments first fathered central banks, the aim was to create prosperity by lowering the interest rate. But later governments favored the central banks with special privileges because they wanted to borrow money themselves and they considered the central banks a source of cheap money. This was a wonderful discovery by the governments. First of all, the governments granted the central bank legal-tender status for their banknotes and freed them from the obligation of keeping their contracts to redeem their banknotes in gold or silver, banknotes which people had accepted voluntarily. (How different would have been Charles I's fate—he was beheaded in 1649—if he had been able to finance his military ventures without worrying about Parliament and the taxpayers.)

Now I want to discuss the consequences of artificially cheap interest rates. It is agreed that the problem is the trade cycle, the credit expansion, that we must fear the boom which results in a depression. The League of Nations made a report, prepared by Professor Gottfried Haberler [1901–1995], on the trade cycle. On its first pages it is clearly stated that the boom which causes the following depression could not occur if the banks did not expand credit. Therefore, one would think the solution would be easy—we have only to prevent the banks from expanding credit or at least from adopting governmental institutions and policies which invite the bank to expand credit. But no—they began to look for another explanation of the cycle. Marxists recognize that one cannot do away with interest entirely by credit expansion, but they deny that lowering it artificially will have evil consequences. They ignore the fact that the rate of interest is the expression of the difference between the market valuation of present goods as against that of future goods.

What really takes place in a credit expansion? Why do we say that certain things may not be done because capital is lacking? Certain projects not feasible today could be effected by cutting down present consumption enough to permit more producers to build more durable investment goods. Everyone contributes a share to the determination of how much is

to be consumed and how much is to be invested. The individual entrepreneur is aware of this fact because of the rate of interest. If people are more willing to save, the interest rate will drop. On the contrary, if they are ready to spend, the rate goes up. The entrepreneur in planning estimates anticipated costs and prices, takes into consideration costs of labor, material, and the rate of interest. If he decides a certain project cannot be done profitably, then it is not done. There are always projects which are not undertaken because the money is used for consumption.

The rate of interest is lowered artificially by credit expansion, so that a project which appeared unfeasible yesterday may today appear profitable. Therefore, the effect of credit expansion and of the lowering of the interest rate is that certain projects which would not have been undertaken are now started. If we think it over, we realize this is not good. There has been no increase in material goods. The only difference is that the bank has created out of nothing additional banknotes or additional checkbook money.

The consequence is that the businessman's calculation is falsified. While before it reflected precisely the conditions of the available factors of production and demonstrated what could be done and what could not be done, it is now falsified, for there exists an additional amount of money substitutes and fiduciary media. The businessman is led, by artificially low interest rates, to embark on projects for which the available supply of capital goods is insufficient. (Suppose a man owns a limited amount of building materials. The contractor makes an error in estimating so that the foundation is too large for the material actually on hand. He should have realized before that the amount of material would not suffice. A crisis results for the master builder.)

It is more difficult in life. The additional demand for projects which would not have been undertaken earlier raises the prices asked for the materials. True, the rate of interest is lower. But prices are higher. The whole thing must stop if the bank's credit expansion comes to an end. But bank credit is elastic, and the banks give more credit.

As wage rates go up, the demand for consumer goods goes up also. But because the boom seems general, the entrepreneur decides to go ahead with the project. Higher prices for the factors of production, including labor, result. And there is a further increase in consumption.

Also of importance is the fact that the banks, when faced with this increased demand, begin to raise their interest rates. In every crisis cautious people tell the bankers, "It is an over-expansion. The expansion should be

cut down and you should not give credit at such easy terms." But the bank says, "Look, we have higher interest rates and there is still an additional demand in spite of this higher rate. Therefore, you can't say our cheap money policy is responsible for the boom."

The relation between price movements and the rate of interest was contributed by Irving Fisher. In a period of rising prices the money lender can make a profit by not lending, by refraining from lending, and by buying goods and selling them himself. On the other hand, the borrower makes an additional profit because when he repays the loan the prices of the goods he made with the borrowed money are higher. Therefore, when there is a tendency for prices to go up, the interest rate is increased by more than the true interest rate. This additional increase in the interest rate is the "price premium." Therefore, a rate which is considered mathematically higher in comparison with the prior rate is still too low for what it should be in consideration of both the interest rate plus the price premium. (In 1923 in Germany, the Reichsbank increased the discount rate to the unheard-of rate of 90 percent, but the price premium at that time was such that the discount rate should have been something like 10,000 percent.)

During a period of speculation stock market prices move up. Everyone becomes enthusiastic and people who know nothing about it enter the stock market. Credit is given to anybody. All these symptoms are well known. Also well known is how such a boom breaks and the consequences and features of such a boom. The problem is what is going on and what makes the whole situation unsound.

In 1929, there was credit expansion in this country and money was cheap. So loans were made to other countries causing the balance of trade to be active. There were more exports from the United States than imports because the other countries didn't have to pay for them—they could pay with bonds. The "wicked" Mr. Schacht[1] was more aware of what was going on than the great Bank of New York. Anybody who wanted to borrow money could get it. (Money was so easy to get from the United States that one small town in Silesia, for instance, built a heated outdoor lake for tropical plants.)

It is said that the characteristic of a boom is general *over*investment.

1 [Hjalmar Horace Greeley Schacht (1877-1970), German financier who held a number of positions in German government, 1923-1943, including president of the Reichsbank and minister of economy.—Ed.]

This is an impossibility. The amounts available for investment are (1) the savings of past years, and (2) that part of the previous year's production equal to the equipment used up in the past years and available for replacement of worn-out tools. (The replacement of old machinery may be made by substituting better or different machines. In this way, many producers have completely changed their production.) Nothing else is available for investment, so there cannot be general *over*investment.

When the available past savings (1) and capital available for replacements (2) are invested according to a plan that *over*estimates the amount of investment goods available, the result for the whole national economy is *mal*investment. Construction is started calling for more material than is available. It has been said that the 1857 crisis in Great Britain was due to the fact that they had built too many railroads. At that time those railroads were unprofitable and capital was lacking for other requirements. Too much circulating capital had been converted into fixed capital. In the crisis, goods for consumption are available at very low prices as there is a surplus of consumer goods.

An individual can overexpand. One can say, "My personal financial situation is very bad. I spent too much money in expanding my business, in building my new factory." The overinvestment idea appeared when this situation, applicable to an individual, was transferred to a nation. But it cannot be true for the whole economic system because only those goods which are available for investment can be used for that purpose. Money can be invested in the *wrong* plans, and too many projects can be started so that some of them cannot be finished, or if finished they can be used only at a loss.

It is obvious what happens. The question is why the situation is suddenly discovered in only a few days, so that the crisis comes overnight. Where there was confidence and optimism, there is depression and despair. Of course, it is only the insight that comes overnight, not the real crisis, which has been building over time.

Because there was no uniformity in credit expansion in various countries in the past, the extent of the credit varied in the different countries. With the demand for foreign exchange and credits, there was a drain of money from some countries. Bankers became frightened. A government official announced, "Maybe we will be forced to restrict credit." The businessmen became frightened: "We need credit. Let us, therefore, get credit as long as there is any possibility." The demand for

credit increased overnight and the banks then had to restrict it. If one bank started, all the others had to restrict it also. Once it started in one country, all other countries had to do the same, so that the restrictions spread all over the world.

If the banks did not restrict credit, could such prosperity be made to last forever? The fact is that in every period of prosperity businessmen have declared, "This is not a temporary boom—this is the final great prosperity of mankind. It will never be followed by a crisis." But it is not possible to make the boom last forever because the boom is built upon paper, on banknotes and checkbook money. It is based on the assumption that there are more goods available than there really are. If the banks did not stop at the last minute, then the credit expansion would have proceeded more and more rapidly until the complete breakdown of the currency occurred, as it did in Germany in 1923. The inflationary movement must come to an end either by a complete breakdown or by voluntary restrictions on the part of the banks involved.

If people were not so optimistic, the crisis would not be so bad, for people would prepare for it. The reasons that make the boom collapse are individual historical facts. The problem *when* the boom comes to an end is decided by accidental factors. But it cannot be avoided. And the later the crisis comes, the more capital has been squandered, and the worse the consequences.

I want to say something about the relation between inflation and credit expansion. Both are very similar, in fact almost the same. The difference is this. In the case of credit expansion, the total additional amount of newly created money goes first into the loan market. It is not spent for consumption, but lent to business. Therefore, the first consequence of credit expansion is that an expansion of business is brought about. And all the other effects come from this stimulation of business. In the case of inflation, the additional money goes first into the hands of a spender—for instance, the government spending for arms or other reasons. Thus, the course of the inflation is different. In essence the two are the same, but their sequences are different, and the characters of the two booms are different. But sooner or later, the spending money from the inflation reaches the investment market also, just as the credit expansion money also finally reaches the spending market.

The idea of qualitative credit control has been popular. We want to give additional credit for good things, for additional industrial plants and

for agriculture, but not for bad people and bad purposes, not for frivolous things. In the final analysis, it doesn't matter where it starts. If the additional money goes first to farmers, the demand for credit among farmers drops and the amount that they would have absorbed without credit expansion is available for creating a boom somewhere else. A boom cannot be directed. No segment of the economy is separate.

9TH LECTURE

The Business Cycle and Beyond

ABOUT THE END OF THE NINETEENTH CENTURY, when people began to realize that there was something questionable about credit expansion, the defenders of this policy found a new excuse. They declared that credit expansion could work in an isolated country which did not connect with the rest of the world through the medium of the gold standard. By abolishing the gold standard and establishing a free-of-gold currency or fiat money system it would be possible to expand credit, lower the rate of interest, and make the country prosperous forever. This attitude was evident among the German *Junkers* who suffered in the 1880s and 1890s from the importation of American cereals. However, they ascribed their misfortune to the gold standard, not to their poor soil and the low yield per acre. They said if it were not for the gold standard they could enjoy a low rate of interest and prosperity.

The influence of these ideas was apparent when the Italian minister of finance declared that a conference of the banks was needed. Toward the end of World War II, these ideas led to the establishment of the International Monetary Fund (IMF). The British government suggested an international bank and in order to create favorable public opinion for an "International Clearing Union" published a pamphlet written by Lord Keynes. This pamphlet, distributed in this country by the British propaganda office, declared that credit expansion was most desirable. In Keynes's own words, credit expansion had brought about the miracle of "converting stones into bread" within nations and it was now necessary to do this on

an international scale. They wanted an international monetary unit. The Bretton Woods Conference produced a document and also an institute with members, a board, and so on. But it is very well known that otherwise they produced nothing. From the beginning, the Conference was abortive and useless.

Why can't credit be expanded on an international basis? The failure of credit expansion is due not to the fact that it has been done on a national basis only, but to the fact that it is impossible to substitute paper for non-existing capital goods. It was not realized that what is needed for an economic expansion is more capital goods, more previous savings. It is true that in the past credit expansion of individual countries came to an end because the pace of the expansion was not the same in other countries. But it would have come to an end anyway.

The real reason why such an international bank cannot succeed is the impossibility of answering this question: "Who should profit from this credit expansion in the short run?" Suppose there was one central bank—let us assume that all political rivalries are forgotten. Such an international bank could increase the amount of credit available either by printing additional banknotes or by giving additional bank credits by checkbook money. But then the problem appears for which no solution is possible—to whom will the new credit, the "easy money," be offered?

Let us assume that the whole additional amount is loaned to one country. This country will enjoy the first boom. Its people will have more money and will bid up the prices of the things they want to buy. Having more money at their disposal, they will be in the favorable position of being able to buy from other countries not yet adjusted to the credit expansion. This first country will be the winner, and the others will be the losers. The other countries will still sell at the old prices but they will have to buy at the new, higher prices.

The questions to be asked are: "Who will get the loans? How will the additional money be distributed?" Every group of countries will propose a system of distribution. The Far East will favor distribution according to population. The advanced countries, for instance, will suggest distribution according to the total amount of yearly production or according to national income. Therefore, such plans are more or less useless. The only value of the IMF, which has been one of the most conspicuous failures of world policies of the last twenty years, is that it occupies office space in Washington.

As all these things proved useless, the defenders of credit expansion, that is, those people who with Marx and the Banking School theorists do not believe that the source of a depression is the credit expansion that precedes it, have proposed elaborate countercyclical methods for minimizing depressions. Considering depressions unavoidable, they want to make them as smooth and as mild as possible by means of government interference. Their idea is that the cycle comes from business or from laissez faire, and the government should interfere with countercyclical programs to make it milder. But this is just the opposite of the case.

The idea of countercyclical measures is that when there is a crisis, business is bad and there are unemployed. The government then should step in with public works. The members of the League of Nations and United Nations committees believe they have discovered something new, but this is nothing new.

The boom comes to an end because the factors of production have been malinvested. The existence of unused capacity in times of depression is an indication of malinvestment, because errors in judgment were made in the past. The solution would be to let wages and prices drop until things started up again. But then someone suggests that the government step in with public works. But why should the government take the factors away from the private works where they are needed? The answer made is that the government should restrict government expenditures as long as there is a boom, and then, when the depression comes, embark on great projects. In a rather childish way these reports always say that there should be a number of projects "on the shelf," already elaborated by the technologists. As soon as the crisis appears, the government should take them off the shelf and start work.

This idea is erroneous because it is based on comparing the individual's situation to that of the whole nation. An individual is cautious; he saves for a rainy day; he may realize that he is prosperous now, but he remembers that his business may not always be successful. When the rainy day comes and he wants to consume, he must sell his savings to others who make use of them.

What should the government do with the taxes it collects if such a public works scheme is anticipated? Should it hoard the money in advance? Should it withdraw money from the system by taxation, thus neutralizing the credit expansion? Advocates of public works feel the government should abstain from spending during the expansion, hoard the money, and when the depression comes spend the money, thus making a

new inflation. Perhaps, they reason, it will be possible in this way to prolong the boom for a few weeks. But it is also possible that the economic system won't cooperate and the pump-priming will fail to work as it failed in the early New Deal.

The other suggestion is that the government hoard, not the money, but the means of production—the machines, tools, and raw materials. This would mean that during the boom the government would make the boom still more "boomy" by appearing on the market as a purchaser of machines, tools, and raw materials.

Sweden boasted that she had solved the problem of the depression by following countercyclical policies. In the 1930s her position was rather peculiar. Sweden exports precisely those things that Germany was consuming for her rearmament effort—iron, lumber, machinery, etc. Sweden's situation in this rearmament boom was like that which Pittsburgh or the entertainment section of Broadway would have enjoyed if they had been independent countries during the war. They would have sold steel and provided amusement to soldiers and munitions works; they would have enjoyed the advantages and had none of the disadvantages of a boom. They would have been the most flourishing sections of the Western hemisphere. This was the situation in Sweden. To say that it was her wonderful policy is another thing. Then, when the war was over, her lead over the whole world was due to her neutrality. You know, it would have been a different story if Hitler had gone into Sweden. One of the Swedish economists was made head of the reconstruction of Europe, which has been a rather miserable experiment.

No boom is possible without credit expansion, and credit expansion must result in catastrophe. When the end of the boom comes and the depression begins, the psychology of the people may make the depression last longer than it would have. (The depression of 1929, for instance, lasted as long as it did because the unions would not accept any substantial lowering of wage rates. This important cost factor of the boom remained for many years and could be remedied only by a new inflation.) The boom is illusory; it is based on the assumption that we are richer than we really are. The boom started projects which could not be executed. The depression means the readjustment of conditions to the real state of affairs. In the depression, the main activity of business consists of salvaging what can be rescued from the boom. The depression lasts as long as necessary to accumulate, by new savings, the capital needed for the continuation of as many enterprises as possible that were started during the boom. The

depression does not mean an impoverishment of the country. Actually it reflects a more accurate picture than the preceding boom. But due to psychological reasons and the political situation caused by the depression, by the drop in prices, and the decline in production, it may go much farther than necessary to re-establish the preceding conditions.

Literature on the trade cycle, especially the earlier material, took sadistic pleasure in describing in detail all the phenomena of the depression. Sometimes paradoxical phenomena appear. But we must not fail to realize that the depression is the return to reality and the attempt to make well, as far as possible, the deficiencies produced by the preceding boom.

During the nineteenth century there was an almost regular recurrence of booms and depressions. This is what has been called the "trade cycle." As soon as conditions begin to be normal, the people and the government call for a new credit expansion and the boom begins again.

The people came to consider the trade cycle as an inevitable trade phenomenon, and they began to study the length of the cycle. All efforts to estimate the length of the trade cycle are more or less fantastic. Because some economists declared that the length of the cycle is eleven years, the idea arose that it is not caused by social and human events, but by cosmic events. The sunspot theory was developed. Such theories are merely guesswork. In the first place the cycle is not eleven years. Also, if true, why does business, which adjusts itself to nature, climate, fertility, and other conditions, never realize that and adjust its activities to the sunspots? There is not the slightest empirical proof that the cycles and sunspots coincide.

But a regularity of some kind was recognized. There is some feeling that the trade cycles are a new development which came with the banking and money system of modern times. But is the trade cycle inevitable? If capitalism continues, will this phenomenon prevail in the future as it has prevailed in the past? The science of human action should not be confused with the natural sciences. Trade cycles originate as the outcome of a human action—credit expansion. Will the trade cycle remain if this knowledge becomes general? Certainly not! If everybody realizes that the credit expansion is the cause of the following depression, governments and people will probably learn that credit expansion is not to their advantage and it will be discontinued.

On the other hand, let us assume that governments and public opinion, in spite of this insight, stubbornly cling to a policy of credit expansions from time to time. Would it not be probable that the reaction of the individual businessman to credit expansion would be different?

Might not business itself, in spite of the governmental incentives, make adjustments so that business would be more stable? Suppose the government embarks on credit expansion and the businessmen feel it is questionable. Instead of expanding their operations because expansion was possible, they might become rather cautious and not expand to the extent possible. This is not such an impossible idea. Remember the New Deal pump-priming. The New Deal wanted a boom but no depression. They wanted to make only the initial movement and then stop expanding credit. But the businessmen realized that the government was planning to stop once the businessmen had started expanding and they did not fall into that trap.

This makes me think the trade cycles which have occurred in capitalistic countries from 1780 on may eventually disappear. It would be a mistake, therefore, to say that the trade cycle belongs to the market economy and will not disappear as long as there is a market economy. First of all, the trade cycle is not a market phenomenon but a phenomenon of the credit expansion which is inserted into the market economy because governments and public opinion believe that the normal operation of the market economy doesn't produce enough bridges and wealth. They believe they have discovered the method for "converting stones into bread." I would say the trade cycle may be only a passing phenomenon, one evidence of the difference between the science of human action and the natural sciences.

What is wrong in the boom may be described as disproportionality between the various branches of production, between the producer goods and consumer goods. Those who try to explain a general boom or general nationwide losses as due to this disproportionality in business production point out that there are durable consumer goods and producer goods. When a new invention, such as a refrigerator, comes on the market, everyone wants to buy. That particular industry booms and expands. But, it is asked, when everybody has bought a new refrigerator, how can the industry continue to expand? The same situation applies, they say, to other businesses—to the building trade, and so on. After everybody who wants these durable and producer goods has bought, the demand falls off and there is the depression. This idea is really fantastic because economic expansion doesn't take place in this way.

The monetary theory of the trade cycle explains the disproportionality in this way. At first only a few buy the new gadget, and then more and more. When the last ones buy, those who bought the early production need replacements. Businessmen are not so stupid as to say that a business which

was good yesterday will necessarily be good tomorrow also. A man embarking on a new business asks himself if there are already enough plants. People do not enter into business as morons. This explains the proportionate sizes of the various industries and the reason why the number of loaves of bread produced and sold on the market is more than the number of coffins. This is why the size of industries is adjusted to the life of their production. It isn't necessary for the government to tell the people what would be surplus production. The calculations of an individual businessman may be erroneous and that man may go bankrupt. Perhaps he increased production in the motor car industry when he should have increased it in the refrigerator industry. He caused a surplus of automobiles and a deficiency of refrigerators. Every day there is loss to some business and gain to others. This means that some businesses will be overstaffed and some understaffed. But it doesn't mean a general boom or a general nationwide loss. A general boom can only be brought about by the illusion which is inherent in the credit expansion.

All attempts to explain the crisis by referring to the mistakes and insufficiencies of businessmen are in error; they fail to take into consideration that such mistakes counteract one another. If one sector of business has made the mistake of overexpansion, there is necessarily underproduction and good business in other branches. Only by general credit expansion can a boom be caused.

The idea that what is wrong with business is that the businessman doesn't see the whole field but only a small segment and, therefore, is bound to make mistakes is Marx's idea of the anarchy of production. Adam Smith and others have answered this in their books. Marx failed to account for the fact that, even if no dictator tells men what to do, there is a tendency in the economic system to give every branch of industry precisely that amount of capital, labor, and products that the consumers demand. Those who guess right make profits; those who are wrong incur losses. The result is that eventually control of the factors of production gets into the hands of those who best satisfy the needs of consumers.

If government, by means of a tax on production, tries to eliminate the profits, to confiscate them, and, therefore, to prevent them from bringing about the consequences which would ensue without these taxes, the operation of the market is considerably weakened. The result is that economic progressiveness and the tendency toward improvement which are inherent in the capitalistic system are eliminated and rigidity enters into the system.

As an example, let us consider a department store developed years ago

by an ambitious young man who started in business with "two shoelaces" [on a "shoestring"]. The market economy prevents the old department store from becoming rigid, conservative, and bureaucratic. If it does, and if the founder's grandchildren operate the store inefficiently, other small shops around the corner will make profits, consume only a part of their profits, and invest the balance. In time the business of the old store will shrink until it may be absorbed by the newcomer, or perhaps sold to new management. Then one of the small shops will be the big department store.

But today things are different. Modern taxation prevents the newcomer from reinvesting the greater part of his funds. The government doesn't legally and officially discriminate against the newcomer; if he makes $250,000 he is taxed the same as an old business making $250,000. But the future business capital is taxed away before the newcomer can build the big store. Therefore, the old department store is somewhat protected; it doesn't need to compete so actively with the gifted newcomer, and it may become negligent. These conditions make it difficult for newcomers to challenge established businesses, the "vested interests." People think the tax laws are extremely progressive, but in reality they are extremely conservative, favoring the existing structure against newcomers. Rigidity results. But this has nothing to do with our subject, credit expansion. However, if there is a credit expansion, the banks prefer to lend to the old rather than to the new firms. This also means that the existing structure tends to be petrified.

I want to say something about the banks and their connection with credit expansion. We must never confuse two very different things which have nothing in common except for the fact that the business is done by the same person, the banker. In one case, the banker may lend his *own* money; he who lends his own money is a money-lender. In this case, there is no question of credit expansion.

In the other case, the banker may lend *other* people's money. The banker who receives deposits from customers and lends this money, other people's money, is a savings bank, an intermediary. The banker may also create fiduciary media, banknotes, and lend them also, usually by crediting his customers' checking accounts. As these two banking functions—lending the deposits of customers and lending fiduciary media—are generally connected in the same enterprises, the government, which controls the business of the fiduciary media, has gained control of the whole lending

business. This has given tremendous powers to the government. If there had never been government interference with the banks, the whole problem would never have appeared.

The defenders of government interference with the issuance of banknotes and checkbook money justify this policy by declaring that "free trade in banking is free trade in swindling." The poor, ignorant people must be protected, they say, against bad banknotes. But no one would be forced to take banknotes if they had not been declared legal tender by the government. The German literature of the mid-nineteenth century considered it really necessary to protect the poor people of Germany from the banks. But the German central bank, the Reichsbank, devalued from 1914, when one U. S. dollar equaled 4.20 marks, to 1923, when it took 4,200,000,000 marks to buy one dollar. The situation today in this country is not that bad, but it is bad enough. The interference of the government in money and banking has made government supreme in devaluing the money. The results today are fantastic compared with the promises and reasons for giving the government this power. Could anything be worse than to have the money in the people's hands shrink from day to day?

Lord Keynes called the gold standard a "barbarous relic." Many books say that the government had to step in because the gold standard failed. But the gold standard didn't fail! The government abolished the gold standard by making it illegal to hold gold. But even today, all international trade is calculated in gold. It is not because gold is yellow and heavy, but because gold alone makes the determination of the purchasing power of the monetary unit independent of the changes in ideas of governments and political parties.

The essence of the market economy is that the economic actions of the individuals are not performed by order of the government but spontaneously by the individuals. This requires also that the money, the medium of exchange, be independent of political influence. If not, the coming years will be nothing but a series of failures of various governmental monetary and credit policies. To prevent this, it is necessary to make everybody realize that there are no Keynesian miracles possible, and that you cannot improve the situation of the people by credit expansion.

I thank you.

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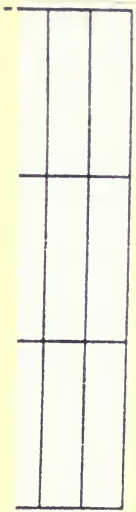

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